

3-1-2004

The States, Balanced Budgets, and Fundamental Shifts in Federalism

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Recommended Citation

Robert W. Shaw, *The States, Balanced Budgets, and Fundamental Shifts in Federalism*, 82 N.C. L. REV. 1195 (2004).Available at: <http://scholarship.law.unc.edu/nclr/vol82/iss3/8>

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The States, Balanced Budgets, and Fundamental Shifts in Federalism

INTRODUCTION.....	1195
I. THE CASE IN POINT: NORTH CAROLINA AND ITS RESTRICTION ON BORROWING.....	1199
II. UNSUSTAINABLE DEVELOPMENTS IN THE LAW AND POLITICS.....	1202
A. <i>Governmental Policy Decisions</i>	1204
1. State Budget	1204
2. Federal Legislation	1207
B. <i>Recent Judicial Trends</i>	1215
C. <i>New Economic Realities</i>	1220
D. <i>Unsolved Policy Issues Facing the States</i>	1223
III. MODERN ALTERNATIVES.....	1226
A. <i>Approaches Taken by Other Governments</i>	1226
B. <i>Procedural Alternatives</i>	1230
C. <i>Substantive Alternatives</i>	1231
D. <i>A Deal: Short Term Debt Creation Plus a Cap on Spending Increases</i>	1232
CONCLUSION	1236

INTRODUCTION

State budgets throughout the United States have come under unprecedented pressure. In recent years, state coffers have gone from flush to dry, and the prevalence of balanced budget requirements in state constitutions and statutes¹ has turned revenue

1. See, e.g., ARIZ. CONST. art. IX, § 5 ("The State may contract debts to supply the casual deficits or failures in revenues . . . but the aggregate amount . . . shall never exceed the sum of three hundred and fifty thousand dollars . . ."); CAL. CONST. art. XVI, § 1 ("The Legislature shall not, in any manner create any debt or debts, liability or liabilities, which shall, singly or in the aggregate with any previous debts or liabilities, exceed the sum of three hundred thousand dollars . . . unless the same shall be authorized by law for some single object or work . . ."); COLO. CONST. art. X, § 16 ("No appropriation shall be made, nor any expenditure authorized by the general assembly, whereby the expenditure of the state, during any fiscal year, shall exceed the total tax then provided for by law and applicable for such appropriation or expenditure . . ."); CONN. CONST. art. III, § 18 ("The amount of general budget expenditures authorized for any fiscal year shall not exceed the estimated amount of revenue for such fiscal year."); DEL. CONST. art. VIII, § 3 ("No money shall be borrowed . . . but pursuant to an Act of the General Assembly, passed with the concurrence of three fourths of all the members elected to each [House]. . ."); IDAHO CONST. art. VIII, § 1 (stating that the "legislature shall not in any manner create any

shortfalls into a nationwide crisis.² A combination of rising costs of and standards for education,³ political trends that have delegated many governmental functions to the state level,⁴ and judicial opinions echoing these political trends by reactivating states' rights doctrines⁵ has given state governments expansive new responsibilities in public policy. These trends have collided with balanced budget requirements in the several states to produce what is essentially a systemic budget crisis.⁶

North Carolina is a case in point. In article V, section 3, of the 1971 North Carolina state constitution, the State is prohibited from enacting unbalanced budgets that would require the State to borrow on its "faith and credit."⁷ This balanced budget provision was also a part of the preceding state constitution of 1868.⁸ As such, the case law that has developed around the balanced budget requirement

debt . . . except in case of war" without a voter referendum); IOWA CONST. art. VII, § 2 ("The state may contract debts to supply casual deficits or failures in revenues, or to meet expenses not otherwise provided for, but the aggregate amount . . . shall never exceed the sum of two hundred and fifty thousand dollars"); MD. CONST. art. III, § 52(5a) (barring all revenue bills and amendments for which expenditures exceed revenues from being introduced in the legislature); ME. CONST. art. IX, § 14 (requiring all non-war debt creation over \$2 million to be submitted to a voter referendum, with some narrow exceptions); MONT. CONST. art. VIII, § 8 ("No state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon."); N.J. CONST. art. VIII, § 2(2) (requiring expected revenues to equal or exceed expected expenditures for appropriations laws); N.Y. CONST. art. VII, § 11 (requiring debt creation to be submitted to a voter referendum); TEX. CONST. art. III, § 49-j ("The maximum annual debt service in any fiscal year on state debt . . . may not exceed five percent of an amount equal to the average of the amount of general revenue fund revenues, excluding revenues constitutionally dedicated for purposes other than payment of state debt, for the three preceding fiscal years."); WIS. CONST. art. VIII, §§ 6, 7 (requiring voter referendum for the creation of debts exceeding caps based on total taxable property values); *see also* Donald B. Tobin, *The Balanced Budget Amendment: Will Judges Become Accountants? A Look at State Experiences*, 12 J. L. & POL. 153, 155 (1996) (reporting that forty-eight of the fifty states have balanced budget requirements by either statute or constitutional provision).

2. IRIS J. LAV, CTR. ON BUDGET AND POL'Y PRIORITIES, *THE STATE FISCAL CRISIS IS IMPEDING ECONOMIC GROWTH; FEDERAL AID TO STATES WOULD BE MOST EFFECTIVE STIMULUS 1* (2003), at <http://www.cbpp.org/2-18-03sfp.pdf> (on file with the North Carolina Law Review).

3. *See infra* Part II.A.

4. *See infra* Part II.A.

5. *See infra* Part II.B.

6. *See infra* Part II (detailing the argument that the state budgeting problem has become systemic).

7. N.C. CONST. art. V, § 3(1).

8. The first two subsections of article V, section 3, are derived from article V, section 4, of the North Carolina Constitution of 1868. The fourth subsection is the progeny of article I, section 6, of the 1868 constitution.

extends continuously over a span of more than one hundred years,⁹ and the original justifications for the balanced budget are a species of nineteenth century policymaking.¹⁰

The changes that have occurred in North Carolina's state government over the past century and a half are striking. Until 1868, North Carolina had no statewide public school system with compulsory attendance,¹¹ the State received most of its tax revenues from the property tax,¹² and social services were undertaken primarily at the local level by churches and other non-governmental charities.¹³ Moreover, the constitution was the result of a Reconstruction effort to reconfigure the State to govern itself responsibly. Thus, the unusual exigencies of that era suggest that, at the least, the provision deserves reexamination in light of the fact that the State now has a viable and stable government, in stark contrast to 1868.¹⁴

Likewise, changes in North Carolina since the adoption of the modern balanced budget provision in 1977¹⁵ have fundamentally altered the outlook of budgetary planning. The fiscal decisions of the last few years have been tremendously difficult, given the social policy goals of the State, the newly-interpreted constitutional requirement of a "sound basic education" for all school-aged children,¹⁶ existing obligations to current and former state employees, and a particularly difficult recession for North Carolina.¹⁷ The 2003 budget¹⁸ was balanced only after closing a gap in the billion-dollar

9. See generally *Hallyburton v. Bd. of Educ.*, 213 N.C. 9, 195 S.E. 21 (1938) (holding that the prohibition on borrowing without a referendum "is unambiguous, plain and direct"); *Univ. R.R. Co. v. W. W. Holden*, 63 N.C. 410 (1869) (holding that the State cannot contract for debt to build a railroad without referendum).

10. See G. Alan Tarr, *Interpreting the Separation of Powers in State Constitutions*, 59 N.Y.U. ANN. SURV. OF AM. L. 329, 335 (2003) (providing an overview of the nineteenth century historical trends that contributed to state budgetary restrictions).

11. See STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS 6 (Charles D. Liner ed., 2d ed. 1995) [hereinafter STATE AND LOCAL] (noting that the 1868 constitutional convention instituted the constitutional provision for a "general and uniform" school system).

12. *Id.* at 7–8. See generally A. FLEMING BELL III & WARREN JAKE WICKER, COUNTY GOVERNMENT IN NORTH CAROLINA 175–233 (4th ed. 1999) (detailing the usage of the property tax).

13. See generally STEPHEN V. MONSMA, WHEN SACRED AND SECULAR MIX: RELIGIOUS NONPROFIT ORGANIZATIONS AND PUBLIC MONEY 5–6 (1996) (noting that religious charities predate the social welfare state).

14. John L. Sanders, *Our Constitutions: An Historical Perspective*, in 35 NORTH CAROLINA'S CONSTITUTION 36–38 (1998).

15. See *infra* notes 30–31 and accompanying text.

16. *Leandro v. State*, 346 N.C. 336, 353, 488 S.E.2d 249, 258 (1997).

17. See *infra* Part III.C.

18. See Current Operations, Capital Improvements, and Finance Act of 2002, ch. 126,

range, using a number of stopgap fixes.¹⁹ After the boom years of the 1990s, in which the budget-makers enjoyed revenue windfalls and talk of greatly increasing the states' power in the federal system,²⁰ North Carolina's capacity to adapt to these many changing circumstances is plainly constrained by its self-imposed balanced budget requirement.

This Comment illustrates how a number of trends in the law, policy preferences, and economic circumstances seriously call into question the old justifications for a constitutionally mandated balanced budget. These trends combine in a way that may not be clear either to lawmakers or the public at large. To date, there are no articles in the academic literature that analyze North Carolina's constitutional restrictions on public debt. In fact, there is a paucity of law review commentary on the reassessment of the state balanced budget requirements. Thus, this Comment makes a contribution to the literature on the contemporary budget woes of state governments.

There are a number of possible alternatives to the state's rather strict constitutional provision. Complete repeal is probably neither politically tenable nor fiscally desirable given the potential for legislative abuse of such unchecked fiscal freedom.²¹ Among the possible mechanisms that would give legislators greater flexibility without handing them a blank check, this Comment argues that a provision which allows the State to borrow using relatively short-term instruments such as five or ten-year bonds without voter approval would be a compelling compromise between fiscal restraint and flexibility. In return for this moderate increase in financial planning capability, the legislature accepts a strict cap on spending growth as an amendment to the state constitution. This deal would take the form of a single referendum that would essentially function as an offer by the General Assembly to the state voters. If accepted and approved, both the government and the taxpayer would get what each wants; the legislature would receive much-needed flexibility to manage the government,²² and the taxpayer would get a guarantee that spending not rise uncontrollably.²³ This fiscal arrangement would, lastly, enhance the General Assembly's capability to manage

2002 N.C. Sess. Laws 291, 291 (2002). See generally Editorial, *A Mess Delayed*, NEWS & OBSERVER (Raleigh, N.C.), Sept. 22, 2002, at A30 [hereinafter, *A Mess Delayed*] (referring to the budget as a "bailing wire-and-chewing gum budget").

19. See *A Mess Delayed*, *supra* note 18.

20. See *infra* Part III.B (discussing federalism jurisprudence by the U.S. Supreme Court).

21. See *infra* notes 221–26 and accompanying text.

22. See *infra* Part III.D.

23. See *infra* Part III.D.

government programs and therefore enhance its argument in debates and negotiations on state-federal balances of power that the state is the optimal level of government for implementation of policy objectives.²⁴

I. THE CASE IN POINT: NORTH CAROLINA AND ITS RESTRICTION ON BORROWING

The purpose of the balanced budget provision of the North Carolina constitution, according to Professor John V. Orth, was to “‘effect the necessary economies’” of the state budget;²⁵ in other words, it mandated fiscal discipline by the General Assembly. The provision originated in the 1868 postwar constitution.²⁶ In that Reconstruction-era constitution, the State was restricted in its power to acquire any new debt until all of its existing bonds were settled.²⁷ In 1936, after those bonds were fully paid, the voters approved a constitutional amendment to enact a more permanent form of anti-debt restriction.²⁸ This provision was incorporated into the 1971

24. See *infra* notes 246–49 and accompanying text.

25. John V. Orth, *North Carolina Constitutional History*, 70 N.C. L. REV. 1759, 1792 (1992) (quoting N.C. CONST. art. III, § 5).

26. Sanders, *supra* note 14, at 36–38.

27. N.C. CONST. art. V, § 4 (repealed 1971). Article V, section 4 provided:

Until the bonds of the State shall be at par, the General Assembly shall have no power to contract any new debt or pecuniary obligation on behalf of the State, except to supply a casual deficit, or for suppressing invasions or insurrections, unless it shall in the same bill levy a special tax to pay the interest annually.

Id. See generally *Univ. R.R. Co. v. W. W. Holden*, 63 N.C. 410, 422 (1869) (holding that casual deficits, invasions, and insurrections were “outside of the ordinary expenses of the government” and therefore abnormal events); J.G. DE ROULHAC HAMILTON, *RECONSTRUCTION IN NORTH CAROLINA* 276 (1914) (chronicling the decisions by the 1868 Constitutional Convention on financial matters).

28. Act of Apr. 29, 1935, ch. 248, § 4, 1935 N.C. Sess. Laws 270, 270 (repealed). The new section 4 read:

The General Assembly shall have the power to contract debts and to pledge the faith and credit of the State . . . for the following purposes: To fund or refund a valid existing debt; To borrow in anticipation of the collection of taxes due and payable within the fiscal year to an amount not exceeding 50 percent of such taxes; To supply a casual deficit; To suppress riots or insurrections, or to repel invasions. For any purpose other than these enumerated, the General Assembly shall have no power, during any biennium, to contract new debts on behalf of the State to an amount in excess of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium, unless the subject be submitted to a vote of the people of the State In any election held in the State . . . under the provisions of this Section, the proposed indebtedness shall be approved by a majority of those who shall vote thereon.

Id.

constitution as the new article V, section 3.²⁹ In 1977, North Carolina voters approved the current version of the debt restriction, one that required the governor to “effect the necessary economies in State expenditures” to ensure an operating balanced budget³⁰ and reformed the language of section 3, which now reads as follows:

(1) Authorized purposes; two-thirds limitation. The General Assembly shall have no power to contract debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State who vote thereon, except for the following purposes:

- (a) To fund or refund a valid existing debt;
- (b) to supply an unforeseen deficiency in the revenue;
- (c) to borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 per cent of such taxes;
- (d) to suppress riots or insurrections, or to repel invasions;
- (e) to meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor;
- (f) for any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium.³¹

The provision is an austere one as state balanced budget requirements go.³² Perhaps the most rigid feature of the section is simply the fact that it is constitutionally mandated. Unlike statutory balanced budget requirements in some states,³³ this one cannot

29. N.C. CONST. art. V, § 3; *see also* INSTITUTE OF GOVERNMENT, CONSTITUTION OF NORTH CAROLINA 1971, at 36 (1970); REPORT OF THE NORTH CAROLINA STATE CONSTITUTION STUDY COMMISSION TO THE NORTH CAROLINA STATE BAR AND THE NORTH CAROLINA BAR ASSOCIATION 48–50 (1968).

30. N.C. CONST. art. III, § 5; *see* JOHN V. ORTH, THE NORTH CAROLINA STATE CONSTITUTION 21 (1993).

31. N.C. CONST. art. V, § 3(1).

32. *See infra* notes 196–211.

33. *See* Lavinia L. Mears, Note, *The Truth About the Balanced Budget Amendment*, 20 SETON HALL LEGIS. J. 592, 607 n.113 (1996) (cataloging statutory and constitutional balanced budget provisions); *see, e.g.*, N.H. REV. STAT. ANN. § 9:8-b (2001) (requiring adoption of a balanced budget, both as projected and as implemented); WASH. REV. CODE ANN. § 39.42.060 (West 2000) (limiting debt based on percentage of gross revenues required for servicing state debt to seven percent).

change as policy needs dictate without resorting to the cumbersome constitutional amendment process.³⁴ Then, there is the absolute nature of the prohibition on borrowing as a practical matter. The six exceptions of article V, section 3, are not routinely part of budgetary planning,³⁵ so in general, the State must balance its budget. Bond referenda do occur,³⁶ but they are blunt, inflexible instruments. They must be approved by the General Assembly in order to be placed on the next statewide ballot,³⁷ so as a matter of course they are something to which the General Assembly rarely resorts.

Exception (f), for example, is not a viable option under normal circumstances, because budget planners can use it only if in the preceding two years they paid down some significant portion of debt.³⁸ Exception (c) allows the State to issue short-term debt within the fiscal year in order to preserve the smooth functioning of the government, but it is clearly not a useful tool when budgetary shortfalls are of a more long-term nature.

The next section of article V applies the same principle to county and city governments.³⁹ Municipal corporations are creatures of the General Assembly's incorporation powers, and their powers to contract for debt are similarly limited: "[t]he General Assembly shall have no power to authorize any county, city or town, special district, or other unit of local government to contract debts secured by a pledge of its faith and credit unless approved by a majority of the qualified voters of the unit who vote thereon."⁴⁰ By implication, the General Assembly may not borrow money for public purposes through the municipalities, so the prohibition on legislatively created debt is watertight throughout state and local government.

34. See N.C. CONST. art. XIII, § 4.

35. For example, after the flood caused by Hurricane Floyd, perhaps the worst natural disaster in North Carolina's history, a good portion of the unforeseen expenses that the state incurred were paid for by the state's rainy day fund, not financed by debt obtained under exception (e). See N.C. CONST. art. V, § 3(1)(e); GOVERNOR'S COMM'N TO MODERNIZE STATE FINANCES, FINAL REPORT 13 (2002) [hereinafter COMM'N TO MODERNIZE STATE FINANCES].

36. See Jane Stancill, *Bonds Proposal Heading to Voters*, NEWS & OBSERVER (Raleigh, N.C.), May 19, 2000, at B1. The school bond referendum was a significant commitment, and it is telling that contracting for debt would be achieved by appeal to education, a policy priority in the state. See Dan Kane, *Easley: Schools Get Break on Cuts*, NEWS & OBSERVER (Raleigh, N.C.), Mar. 22, 2002, at A1.

37. See sources cited *supra* note 36.

38. N.C. CONST. art. V, § 3(1)(f).

39. *Id.* art. V, § 4.

40. N.C. CONST. art. V, § 4(2). Municipalities can invoke the same exceptions that the State can invoke under section 3(1). See *id.*

Thus, the budget crises of state and local governments are interconnected in a way that those of the federal and state governments are not.⁴¹ Further, North Carolina funds a major portion of local governmental activities through state grants to municipalities.⁴² Although withholding monies from state coffers promised to the localities is an extreme measure, it became an important method by which the State balanced its own budget in fiscal year 2002, much to the chagrin of the hapless municipalities.⁴³ Withholding \$330 million that was to go to local governments⁴⁴ went a long way towards recovering the nearly \$1 billion budget shortfall, but it was a bitter pill to swallow for the municipalities that depended on the money.⁴⁵

II. UNSUSTAINABLE DEVELOPMENTS IN THE LAW AND POLITICS

One of the chief contentions of this Comment is that a number of seemingly independent trends have combined to create the recent fiscal gaps and that these trends do not appear to be receding. The nature of state and local government is radically different from 1868, when the original balanced budget requirement was formally debated at the postwar constitutional convention.⁴⁶ State and local

41. See HOWARD CHERNICK & ANDREW RECHOVSKY, *LOST IN THE BALANCE: HOW STATE POLICIES AFFECT THE FISCAL HEALTH OF CITIES* 3, 5–6 (2001), at <http://www.brookings.edu/es/urban/chernick/chernick.pdf> (on file with the North Carolina Law Review); DANIEL R. MANDELKER ET AL., *STATE AND LOCAL GOVERNMENT IN A FEDERAL SYSTEM* 239–48 (5th ed. 2002).

42. STATE AND LOCAL, *supra* note 11, at 10–14.

43. Dan Kane, *\$2 Billion*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 26, 2003, at A19; see also David Rice, *Money Was Off-Limits, Attorneys Say*, WINSTON-SALEM J., Dec. 18, 2003, at B1 (reporting on a trial hearing in a lawsuit by counties to recover withheld funds); David Rice, *State Is Backing Out on Promise, Mayor Says*, WINSTON-SALEM J., Mar. 6, 2003, at A1 [hereinafter Rice, *State Is Backing Out*] (reporting on additional payment withholdings proposals in budget negotiations and lobbying efforts to prevent the measures).

44. Rice, *State Is Backing Out*, *supra* note 43.

45. See, e.g., Carey Hamilton, *Some Say Tax Plan Is Uneven; Counties, Cities Once Dependent on Tobacco Would Be Hardest Hit*, WINSTON-SALEM J., July 29, 2002, at B1 (detailing the fiscal impact of the proposed tax plan on affected cities). But see MICHAEL LOWREY & ERIK ROOT, *BY THE NUMBERS* 2003, at 3–4 (2003) (asserting that current revenue sources for municipalities are not inadequate despite withholding by the state), at http://www.johnlocke.org/acrobat/homePageFeatures/local_tax_report_2003.pdf (on file with the North Carolina Law Review).

46. See generally JOURNAL OF THE CONSTITUTIONAL CONVENTION OF THE STATE OF NORTH-CAROLINA, AT ITS SESSION 1868 (Joseph W. Holden ed., 1868) (chronicling the proceedings of the 1868 state constitutional convention). In the postwar constitutional convention, there was substantial concern over the deterioration of North Carolina's financial position. See Record of the 1868 Constitutional Convention 756–64 (compiled 1971) (unpublished record of the proceedings of the 1868 North Carolina constitutional

governments are also substantially different than they were at the time of the ratification of the new constitution in 1971,⁴⁷ and the budgetary realities and policy trends of recent years have continued to change the fiscal playing field in ways that might not have even been envisioned in the mid-1990s, when North Carolina and other states had not yet faced the financial difficulties of recent years.⁴⁸

convention compiled by Joseph Ferrell, University of North Carolina J. Albert Coates Professor of Public Law and Government) (on file with the North Carolina Law Review). General J.C. Abbott, reporting on behalf of the Committee on Finance, *see id.* at 750, stated, “[North Carolina’s] honor and credit, once the very highest of any Southern State, is now the lowest, and this results not from any necessity, but from neglect and failure to act in the line of her true policy and true interest.” *Id.* at 760. In his speech to the convention, he regarded this issue to be one of the chief needs of the state in this critical time in its history:

Mr. President, this is no fancy sketch, no mere flight of the imagination. All this can be done, and done speedily. The dark pall that once rested upon the State like the miasma of death is now lifted forever, and it remains for us to accomplish the rest. Adopt a sound financial policy, a liberal Constitution and a wisely administered government, and the work is accomplished. Let us then open our doors. Let us take away the only remaining obstruction. Let us restore to the good old State her ancient fair fame, her honor, her credit, her time-honored name for honesty and integrity. Do this and the most enthusiastic among us does not dream of what is in store for North Carolina.

Id. at 762.

The postwar debt load, according to Abbott, had been neglected and was hampering the return of the state to fiscal normalcy. *Id.* at 760. He therefore proposed that North Carolina follow the lead of Missouri, also a slave state, and resolve to make debt repayment a priority of the new government. *Id.* at 760–62. His proposal, therefore, called for a constitutional requirement that the State not contract any more debt until the existing bonds were at par. *Id.* at 750. His proposed additional provision allowed for a lending of state credit only upon the passage of a voter referendum. *Id.* The convention debated the practicality of repaying the debt at that time, given the dire fiscal straits of the state at the time and the proposed system for taxation. *Id.* at 770–72. However, Abbott’s proposal, which included a companion constitutional provision requiring repayment of the debt, was ratified by the convention. *Id.* at 772. These were codified in the North Carolina Constitution of 1868 in article V, sections 4 and 5. In this respect, the debates reveal that the overriding problem that gave rise to this approach to state finance was the fiscal disaster that the North Carolina faced in the aftermath of the Civil War. *See generally* NORTH CAROLINA STANDARD (Raleigh, N.C.), Mar. 11, 1868, at 2–3 (reporting on the business conducted at the convention and printing the major speeches that were given).

47. *See* COMM’N TO MODERNIZE STATE FINANCES, *supra* note 35, at 3.

48. *See, e.g.*, NATIONAL ASS’N OF STATE BUDGET OFFICERS, BUDGET SHORTFALLS: STRATEGIES FOR CLOSING SPENDING AND REVENUE GAPS 1 (2002) [hereinafter BUDGET SHORTFALLS] (summarizing some of the 2002–03 state budgetary shortfalls and remedies that states adopted), at <http://www.nasbo.org/Publications/PDFs/shortfallstrategies-3rd.pdf>. (on file with the North Carolina Law Review). *See generally* Susan P. Fino, *De Tocqueville or Disney? The Rehnquist Court’s Idea of Federalism*, 66 ALB. L. REV. 765 (2003) (discussing the recent fiscal crisis for states as a result of taxing limits and spending mandates); Lawrence O. Gostin, *When Terrorism Threatens Health: How Far Are Limitations on Personal and Economic Liberties Justified?*, 55 FLA. L. REV.

There are essentially three types of trends that have produced these changed circumstances: changes in government policy, judicial trends in constitutional jurisprudence, and new economic realities.

A. *Governmental Policy Decisions*

1. State Budget

Any overarching discussion of the state budget in North Carolina begins with education, which is by far its largest appropriations category. Education constituted fifty-six percent of the state budget in 2002–03,⁴⁹ the vast majority of which was for primary and secondary school education.⁵⁰ Overall, state citizens enjoy a relatively low total tax burden,⁵¹ and public instruction is funded almost entirely by the state budget and not local budgets, in contrast to many other states.⁵²

A number of policy initiatives in the 1990s charted a new course for public education in North Carolina. During these years Governor Jim Hunt made the public school system a priority,⁵³ leading to numerous new programs. Among them were Smart Start,⁵⁴ a state-

1105 (2003) (referring to the difficulty of preparing for the terrorist threat in a climate of state budgetary crisis); see also LAV, *supra* note 2, at 1–2 (describing the fiscal crisis, the states' response to it, and its effect on the nationwide economy).

49. Total expenditures were \$14.78 billion, and the State spent \$8.36 billion on education during that period. See Current Operations and Capital Improvements Appropriations Act of 2001, ch. 424, pt. I, § 2.1, 2001 N.C. Sess. Laws 1670, 1671–72 (2001).

50. See *id.* (allocating to the Department of Public Instruction \$5.9 billion of the \$8.36 billion total education expenditures).

51. In total tax burdens, North Carolina ranked thirty-fifth out of the fifty states in 2002. TAX FOUNDATION, SPECIAL REPORT: AMERICA CELEBRATES TAX FREEDOM DAY 9 (April 2002), at <http://www.taxfoundation.org/images/sr112.pdf> (on file with the North Carolina Law Review).

52. STATE AND LOCAL, *supra* note 11, at 11. In the early 1930s, the State took over financing public education, road construction, and prison administration and construction. *Id.*

53. See Todd Silberman, *Education Chief Gives Nod to N.C.*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 6, 2000, at B3 (reporting that U.S. Education Secretary Richard Riley's visit to the state honored the accomplishments of the Hunt administration in the area of education). Secretary Riley said of Governor Hunt's efforts:

"North Carolina, under Gov. Hunt, has become a national leader in improving education," Riley said in a written statement. "Gov. Hunt has worked tirelessly to improve teacher quality, raise standards, expand early childhood education, give children the learning power of technology and support improvements in public education. When a governor like Jim Hunt makes education a top priority, it makes all the difference to our children—and our nation."

Id. (quoting Richard Riley, U.S. Secretary of Education).

54. Amy Gardner, *A Farewell Flourish*, NEWS & OBSERVER (Raleigh, N.C.), Dec. 23,

level version of the federal government's Head Start program for early childhood educational development, initiatives designed to track student progress more effectively,⁵⁵ and an ambitious program to elevate teaching standards by raising teacher pay and weeding out underachieving teachers.⁵⁶ The results have been impressive. In terms of teacher training, North Carolina rose from having only eight teachers receiving certification by the National Board of Professional Teaching standards in 1994 to leading the nation in certification as of 2000–01.⁵⁷ Teacher pay has risen from low levels to approximately the national average,⁵⁸ and SAT scores have seen significant improvement.⁵⁹ Higher standards have come at a cost, however, as the public school budget for the state has risen twenty-four percent from the 1997–98 school year to the 2002–03 school year.⁶⁰

Criminal justice initiatives of the 1990s were another significant legislative priority that increased the state's long-term financial obligations. Structured sentencing legislation,⁶¹ including the "three-strikes-and-you're-in" provision for habitual felons, was also

2000, at A1.

55. *See id.*

56. *Id.*; *see also* NORTH CAROLINA DEPT. OF EDUC., *STAYING THE COURSE FOR SUPERIOR SCHOOLS: 2000–2001 ANNUAL REPORT* 12–13 (2001) [hereinafter *STAYING THE COURSE*] (reporting on the progress made in improving overall teacher quality), available at http://www.ncpublicschools.org/state_board/annualrpt/00-01/ (on file with the North Carolina Law Review).

57. *Id.* at 13. *But see* GEORGE C. LEEF, NATIONAL BOARD CERTIFICATION: IS NORTH CAROLINA GETTING ITS MONEY'S WORTH? 2–10 (North Carolina Education Alliance, 2003) (critiquing board certification initiatives in North Carolina as being a waste of money and ideologically biased), at <http://www.johnlocke.org/acrobat/policyReports/leefcertification2.pdf> (on file with the North Carolina Law Review); KAREN PALASEK, GRADING OUR SCHOOLS 2002: NCEA'S FIFTH ANNUAL REPORT TO NORTH CAROLINA TAXPAYERS AND PARENTS 2–3 (2002) (criticizing state education assessment measures as confusing), at http://www.johnlocke.org/acrobat/policyReports/gos_2002-web.pdf (on file with the North Carolina Law Review).

58. *See* *STAYING THE COURSE*, *supra* note 56, at 12–13.

59. *See id.* at 6; PALASEK, *supra* note 57, at 7 (providing district-specific assessments of public school improvements); Gardner, *supra* note 54. Palasek contends that SAT performance is not impressive and remains sub par. PALASEK, *supra* note 57, at 7.

60. Compare Current Operations and Capital Improvements Appropriations Act of 1997, ch. 443, pt. II, § 2, 1997 N.C. Sess. Laws, 1344, 1345 (allocating public schools \$4,510,318,741 for 1997–98), with Current Operations and Capital Improvements Appropriations Act of 2001, ch. 424, pt. I, § 2.1, 2001 N.C. Sess. Laws 1670, 1671 (allocating public schools \$5,922,188,546 for 2002–03). The amount allocated for the 2002–03 budget is twenty-four percent higher than the amount allocated for 1997–98. *But see* COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 19 (noting that enrollment increases accounted for part of the increase in education funding from 1999 to 2000, along with increased teacher compensation and higher spending on education programs).

61. *Id.*; *see* Structured Sentencing Act, ch. 538, 1993 N.C. Sess. Laws 2298, 2298 (codified at N.C. GEN. STAT. §§ 15A-1340.10 to 1340.23 (2001)).

supported by Governor Hunt.⁶² Passed in a special session of the General Assembly to deal with crime in 1994, the “three strikes” statute requires that persons convicted of three violent felonies be given life prison sentences without parole eligibility.⁶³ These structured sentencing initiatives also imposed more formal requirements on trial courts by specifying mandatory minimum prison terms.⁶⁴ Whether or not these laws were good policy,⁶⁵ they certainly had the effect of burgeoning prison populations in the state, thereby imposing continuing expenditures on future state budgets to maintain this population.⁶⁶ The fiscal impact of burgeoning prison populations is long-term and inflexible, given that prison construction as well as inmate incarceration compel the State to enter into large prison construction and management contracts.⁶⁷ Thus, these budgetary items are not generally discretionary spending that can easily be dropped in times of financial hardship.

62. Gardner, *supra* note 54 (noting Governor Hunt’s support for the “three strikes” legislation); see N.C. GEN. STAT. § 14-7.12 (2001) (mandating life without parole for violent habitual felons who are convicted of a third violent felony); see also N.C. GEN. STAT. § 14-7.7 (2001) (defining “violent habitual felon”).

63. See § 14-7.12.

64. See Structured Sentencing Act, ch. 538, sec. 1, 1993 N.C. Sess. Laws 2298, 2307–11 (codified at N.C. GEN. STAT. §§ 15A-1340.10 to 1340.23 (2001)). An example of the structured sentencing initiative can be found at section 15A-1340.17(c), which established the sentencing requirements for a given class of crime and the convict’s prior criminal record.

65. See RONALD F. WRIGHT, *MANAGING PRISON GROWTH IN NORTH CAROLINA THROUGH STRUCTURED SENTENCING* 13 (1998); Walter L. Gordon III, *California’s Three Strikes Law: Tyranny of the Majority*, 20 WHITTIER L. REV. 577 *passim* (1999) (attacking California’s approach from an array of angles, including political self-interest of bill sponsors and the ineffectiveness and racially unequal effects of the law); Meredith McClain, Note, “Three Strikes and You’re Out”: *The Solution to the Repeat Offender Problem?*, 20 SETON HALL LEGIS. J. 97, 124–26 (1996) (expressing skepticism that three strikes legislation around the country would impact crime rates or attack the root causes of crime).

66. See WRIGHT, *supra* note 65, at 8–9 (describing the projected cost and incarceration rate increases as a result of structured sentencing bills); Kane, *supra* note 43 (noting that the burgeoning prison population required the construction of three new prisons at a cost of \$60 million). The total Department of Corrections budget for 2001 reached \$923 million, or over six percent of the total state budget. See Current Operations and Capital Improvements Appropriations Act of 2001, ch. 424, pt. I, § 2.1, 2001 N.C. Sess. Laws 1670, 1673.

67. STATEWIDE ACCOUNTING DIV., OFFICE OF THE STATE CONTROLLER, NORTH CAROLINA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2002, at 124 (2002) [hereinafter 2002 CAFR] (summarizing the long-term prison construction contracts that North Carolina entered into during the fiscal year 2002 and noting North Carolina’s contract for a twenty-year prison lease estimated to cost \$370 million), available at http://www.osc.state.nc.us/financial/02_cafr/2002_CAFR.pdf (on file with the North Carolina Law Review).

2. Federal Legislation

Federal policy choices in recent years have also impacted state budgets in significant ways. Perhaps foremost, the North American Free Trade Agreement of 1994⁶⁸ ("NAFTA") impacted North Carolina's revenue stream directly by lowering the state's gross economic output. NAFTA affected manufacturing in the state by facilitating the relocation of facilities to Mexico.⁶⁹ Because of the sheer size of the manufacturing industry, North Carolina suffered more job losses than any other state as a result of the free trade policies of the 1990s and the first few years of the twenty-first century.⁷⁰ So, while the state's consumers certainly benefited from lower product prices, which might give them more net purchasing power as a group,⁷¹ the overall effect on state revenues was likely a decrease in tax revenues. This decrease resulted because the state's individual and corporate income tax, which is more directly impacted by plant closings, constitutes a substantially larger percentage of state

68. North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289. See generally North American Free Trade Agreement Implementation Act of 1993, Pub. L. No. 103-182, 107 Stat. 2057 (codified in scattered sections of 19 U.S.C.) (approving the treaty by enacting legislation necessary to implement it).

69. James R. Giermanski & Peter Lodge, *An Analysis of NAFTA and Textile Closings in North Carolina*, 2 J. TEXTILE & APPAREL, TECH. & MGMT. 1, 1-4 (2002) (analyzing the impact of NAFTA and competition from Mexico and Canada on plant closings), at http://www.tx.ncsu.edu/jtatm/volume2issue3/articles/Giermanski/Giermanski_full.pdf (on file with the North Carolina Law Review). This study documents that fifteen percent of North Carolina firms that closed in the seven years following NAFTA ratification reported that NAFTA was the reason for their closing. *Id.* at 4; see also JOBS WITH JUSTICE & CITIZEN'S TRADE CAMPAIGN, NAFTA'S IMPACT ON NORTH CAROLINA: JOB LOSS HAS LED TO DOWNWARD PRESSURE ON WAGES AND LIVING STANDARDS 4-14 (2001) (detailing the plant relocations from North Carolina to Mexico and elsewhere in an advocacy group's policy paper), available at <http://www.jwj.org/global/FTAA01/NC.pdf>; STATEWIDE ACCOUNTING DIV., OFFICE OF THE STATE CONTROLLER, NORTH CAROLINA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2000, at 9 (2000) [hereinafter 2000 CAFR] (citing manufacturing job losses as a growing problem for the economy and state budget), available at http://www.osc.state.nc.us/financial/00_cafr/00CAFR.pdf (on file with the North Carolina Law Review). See generally Janet Patricia Farmer, Comment, *NAFTA and the Textile and Apparel Industries: "Made in North America"*, 19 N.C. J. INT'L L. & COM. REG. 293 (1994) (overviewing the economic forces at work in the textile industries under NAFTA).

70. Amy Gardner, *Layoffs Prime Election Issue*, NEWS & OBSERVER (Raleigh, N.C.), Oct. 27, 2002, at A1 ("North Carolina has lost more jobs to Latin America and Asia than any other state in the nation."). But see Governor James B. Hunt, Jr., *Governor's Mission to Latin America, August 16-28, 1999*, 25 N.C. J. INT'L L. & COM. REG. 519, 520-21 (2000) (providing an overview of the export benefits of NAFTA to the North Carolina economy in an article authored by the sitting governor).

71. See Hunter R. Clark & Amanda Velazquez, *Foreign Direct Investment in Latin America: Nicaragua—A Case Study*, 16 AM. U. INT'L L. REV. 743, 756-57 (2001) (describing consumers' economic gains under a free trade regime).

tax revenues than the sales tax, which would benefit from increased sales.⁷² Nevertheless, the free trade sentiments of many state politicians, even in a severely affected state like North Carolina, prevailed in the policy debate,⁷³ leading to the passage of supporting legislation⁷⁴ and treaty ratification.⁷⁵ The pace of manufacturing facilities moving overseas has more recently begun to pinch the state as a whole, exacerbating what was already a stubborn recession.⁷⁶

NAFTA's unemployment effects also indirectly impacted the state budget indirectly through increased outlays relating to unemployment benefits. The state's Unemployment Insurance Fund,⁷⁷ funded primarily through employer taxes and secondarily through federal grants,⁷⁸ declined from a balance of \$1.75 billion in 1997⁷⁹ to \$793 million in 2002.⁸⁰ The impact of foreign competition on the state budget is significant for two reasons. First, it demonstrates how much recessions can increase state budgetary outlays if the State

72. See 2002 CAFR, *supra* note 67, at 32 (reporting that individual and corporate income tax revenues for the fiscal year ending on June 30, 2002, totaled \$7.8 billion, whereas sales tax revenues were \$3.8 billion). Total income tax revenues funded thirty percent of this budget, as opposed to the sales tax revenues, which funded only fourteen percent. *Id.* at 33. Precisely analyzing the net effect of NAFTA on tax revenues would require accounting for the increased income taxes paid by retailers who import products at lower prices, as well as the decrease in sales taxes due to the lower consumption by those who have suffered an income loss due to plant closings. Without delving into a comprehensive econometric analysis, the substantial income losses due to plant closings, *see supra* notes 69–70, are probably much larger than the incremental gains in sales tax revenues caused by lower prices for consumable goods. In fact, there is strong evidence that sales tax receipts are particularly vulnerable to economic downturns in North Carolina. COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 5, 10. In other words, the income effect resulting from lower wages dominates the substitution effect benefits of lower prices.

73. See Clark & Velazquez, *supra* note 71, at 756–57.

74. North American Free Trade Agreement Implementation Act, Pub. L. No. 103-182, 107 Stat. 2057 (1993) (codified in scattered sections of 19 U.S.C.).

75. 19 U.S.C. § 3311(a) (2000). See generally North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., 32 I.L.M. 289 (lowering barriers to international trade in North America).

76. See *supra* note 72.

77. See N.C. GEN. STAT. § 96-6 (2001).

78. See 2000 CAFR, *supra* note 69, at 150 (reporting \$117 million in taxes receivable and \$1.3 million in “intergovernmental receivables”).

79. STATEWIDE ACCOUNTING DIV., OFFICE OF THE STATE CONTROLLER, NORTH CAROLINA COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 1997, at 136 (1997), available at http://www.osc.state.nc.us/pdfs/97_caf/97CAFR.PDF.

80. 2002 CAFR, *supra* note 67, at 56. Much of the decline came during the manufacturing recession of 2000–02. See *supra* notes 69–72 and accompanying text (analyzing the economic forces that accompanied the manufacturing downturn in 2000–2002). The fund reported assets of \$1.71 billion in 2000. 2000 CAFR, *supra* note 69, at 150.

has decided to undertake increased responsibility for job losses under a free trade regime and a globalized economy.⁸¹ The economic rationale for this correlation is that “[s]ocieties seem to demand (and receive) an expanded government role as the price for accepting larger doses of external risk,”⁸² risk which comes from increased volatility and competition under free trade.⁸³

The second reason why free trade agreements such as NAFTA and the World Trade Organization⁸⁴ (“WTO”) create a systemic change to the state budget is the economic concept commonly referred to as the “compensation principle.”⁸⁵ The compensation principle states that, while winners—here, consumers—gain more under free trade than losers—here, manufacturing workers—all will be better off if the winners compensate the losers for their loss.⁸⁶

81. See Dani Rodrick, *Why Do More Open Economies Have Bigger Governments?*, 106 J. POL. ECON. 997, 997–1006 (1998) (modeling the incentive structure for governments to expand fiscal responsibilities under a free trade regime, with empirical evidence for the theory).

82. *Id.* at 998.

83. See *id.*

84. See General Agreement on Tariffs and Trade—Multilateral Trade Negotiations (The Uruguay Round): Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125 [hereinafter WTO agreement] (embodying the WTO Agreement and its attendant instruments). The World Trade Organization constitutes a forum for adjudicating trade disputes under its accompanying treaties and is committed to trade liberalization. WTO Agreement, paras. 1–7.

85. See JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 114 (3d ed. 2000) (defining the compensation principle). Professor Stiglitz defines the compensation principle for public policy decisions generally. *Id.*; see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2, at 14–16 (6th ed. 2003) (defining the principle of compensation using the economic concepts of Pareto efficiency and Kaldor-Hicks efficiency).

86. In the context of the decision to choose a policy of free trade, the compensation principle implies that, while aggregate economic gains always exceed losses when lowering trade barriers, there may be winners and losers after free trade. If winners compensate losers for their loss, the losers will not be made worse off, while the winners are made better off. Generally, however, compensation will occur via government spending, given that government is the least cost avoider; in other words, it is easier for the government to enact a general welfare program, such as unemployment insurance and worker retraining, than for individual winners to find individual losers and compensate them through private transactions. Further, because the government makes the choice to make free trade agreements, the government is the logical entity to carry out the compensation system, such that the legislature can enact both the free trade agreement and the domestic compensation system simultaneously. See Alía Adserà & Carles Boix, *Trade, Democracy, and the Size of the Public Sector: The Political Underpinnings of Openness*, 56 INT’L ORG. 229, 229–31 (2002) (outlining the theory of how free trade decisions and public sector expansion occur in tandem); Rodrick, *supra* note 81, at 1028–29. See generally Willem Thorbecke & Christian Eigen-Zucchi, *Did NAFTA Cause a “Giant Sucking Sound”?*, 23 J. LAB. RES. 647 (2002) (analyzing the net impact of NAFTA on trade and aggregate U.S.

Because the government makes the decision to sign free trade agreements, the typical way in which the winners bargain with the losers is through the political process.⁸⁷ Government will also, generally, be the least cost avoider in a compensation scheme; in other words, projects such as unemployment insurance and worker retraining are funded by the winners through taxation, and government is the least expensive mechanism by which to carry out the compensation.⁸⁸ In that respect, a global and liberalized economy depends on an expanded and responsive public sector, because in the absence of compensation, those that would lose under a free trade regime would obstruct the ratification of free trade agreements such as NAFTA and the WTO. North Carolina has accepted expanded governmental responsibility, responsibility that is at its highest when the economy is at its lowest ebb in the business cycle, as the price for the benefits of free trade.⁸⁹ The difficult irony, of course, is that state revenues are depressed⁹⁰ when the need for spending is most immediate.

Lastly, the United States Congress has enacted legislation changing the balance of federalism in recent years. The Welfare Reform Act of 1996⁹¹ was perhaps the most public of a number of national initiatives to return policy control to the state level.⁹² The Act, along with others like the Unfunded Mandates Reform Act,⁹³ were flagship bills in the effort to reinvigorate the politics of decentralization in policy matters.⁹⁴ While the Unfunded Mandates

economic welfare).

87. See Adserà & Boix, *supra* note 86, at 229–30.

88. See *id.*

89. See *supra* notes 77–83 and accompanying text (explaining the cost of economic downturns to the unemployment assistance program).

90. See COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 5, 10.

91. Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105 (Aug. 22, 1996) (codified in scattered sections of the U.S.C.).

92. See ROBERT F. NAGEL, *THE IMPLOSION OF AMERICAN FEDERALISM* 71 (2001) (including the Act among a number of setbacks to the nationalist interests). See generally Sheryll D. Cashin, *Federalism, Welfare Reform, and the Minority Poor: Accounting for the Tyranny of State Majorities*, 99 COLUM. L. REV. 552 (1999) (discussing in critical terms the Welfare Reform Act, the Personal Responsibility and Work Opportunity Reconciliation Act, and other recent decentralization initiatives).

93. Pub. L. No. 104-4, 109 Stat. 48 (1995) (codified as amended in scattered sections of 2 U.S.C.); see NAGEL, *supra* note 92, at 71; Recent Legislation, *Federalism—Intergovernmental Relations—Congress Requires a Separate, Recorded Vote for Any Provision Establishing an Unfunded Mandate—Unfunded Mandates Reform Act of 1995*, Pub. L. No. 104-4, 109 Stat. 48, 109 HARV. L. REV. 1469, 1469–74 (1996) (analyzing the new legislative rules on unfunded federal mandates).

94. See Evan H. Caminker, *State Sovereignty and Subordinacy: May Congress Commandeer State Officers to Implement Federal Law?*, 95 COLUM. L. REV. 1001, 1003–04

Reform Act, which applies to all new federal regulatory actions that apply to the states,⁹⁵ largely purports to reduce the budgetary pressures on the states coming from unfunded mandates,⁹⁶ its symbolic importance as guarantor of state sovereignty under a reinvigorated process federalism⁹⁷ merits its inclusion in this discussion.

Further, the Unfunded Mandates Reform Act also includes requirements that federal laws state explicitly when state laws are preempted,⁹⁸ thus enacting a prophylactic against implied preemption and shifting the burden to parties asserting preemption to prove that a federal law supersedes state law. Thus, the Act maintains the integrity of the state regulatory frameworks in addition to bolstering their budgetary autonomy. Regulatory preemption was also the focus of disputes over several Clinton administration Executive Orders.⁹⁹ In particular, Executive Order 13,083 in 1998¹⁰⁰ implied an expansion of federal regulatory authority¹⁰¹ and suggested that the burden to disprove preemption or to demonstrate the merits of a state waiver from regulations rested with the state.¹⁰² After state and local

(1995) (describing the Unfunded Mandates Reform Act as a federal response to the problems of state compliance with federal mandates); Elizabeth Garrett, *Enhancing the Political Safeguards of Federalism? The Unfunded Mandates Reform Act of 1995*, 45 U. KAN. L. REV. 1113, 1136–37 (1997) (discussing the purposes of the Act in relation to federalism concerns). See generally Steven P. Croley & William F. Funk, *The Federal Advisory Committee Act and Good Government*, 14 YALE J. ON REG. 451, 465–66 (1997) (noting the symbolic importance of the Unfunded Mandates Act in shifting the policy focus toward greater regulatory flexibility at the state level).

95. 2 U.S.C. § 1531 (2000).

96. See *id.* § 1501(2); see also CONTRACT WITH AMERICA 125 (Ed Gillespie & Bob Schellhas eds., 1994) (criticizing unfunded mandates).

97. “Process federalism” refers to the legal principle “that the states must look primarily to the political process for protection from unwanted federal intrusions on their sovereignty.” John E. Taylor, Note, *AT&T Corp. v. Iowa Utils. Bd.: The Supreme Court Recognizes Broad FCC Jurisdiction over Local Telephone Competition*, 78 N.C. L. REV. 1645, 1693 (2000). But see William Marshall, *American Political Culture and the Failures of Process Federalism*, 22 HARV. J.L. & PUB. POL’Y 139, 141–44 (1998) (arguing that process federalism did not fully take hold in the Republican Congress).

98. See Unfunded Mandates Act of 1995, Pub. L. No. 104-4, § 423(e), 109 Stat. 48 (codified at 2 U.S.C. § 658b(e)). The Act requires that “the committee report accompanying the bill or joint resolution shall contain, if relevant to the bill or joint resolution, an explicit statement on the extent to which the bill or joint resolution is intended to preempt any State, local or tribal law, and, if so, an explanation of the effect of such preemption.” *Id.*

99. See Jennie Holman Blake, Comment, *Presidential Power Grab or Pure State Might? A Modern Debate Over Executive Interpretations on Federalism*, 2000 BYU L. REV. 293, 293–94 (2000).

100. Exec. Order No. 13,083, 3 C.F.R. 146 (1998).

101. See *id.* at § 3(d).

102. See *id.* at § 5; Blake, *supra* note 99, at 300–01.

governments complained about this change in policy, President Clinton suspended the Order¹⁰³ and later replaced it with a new Executive Order¹⁰⁴ that restored the regime of deference to the states that had been federal executive policy since the Reagan administration.¹⁰⁵ Thus, proponents of state autonomy have been successful not only by lobbying the U.S. Congress, but also through lobbying of the federal executive branch by state and local governments.

Academic responses to this “new federalism”¹⁰⁶ have been mixed,¹⁰⁷ but the elections of 2000 and 2002 placed the national government squarely in the hands of the Republican Party, a party that generally favors decentralized control of regulatory matters and social policy.¹⁰⁸ While there are important reasons why the federal government’s power may be expected to increase in some areas,

103. Exec. Order No. 13,095, 3 C.F.R. 202 (1998).

104. Exec. Order No. 13,132, 3 C.F.R. 206 (1999), *reprinted as amended in* 5 U.S.C. § 601 (2000).

105. Blake, *supra* note 99, at 295.

106. See generally Cynthia A. Baker & Jonathan D. Mattingly, Symposium, *National Power and State Autonomy: Calibrating the New “New Federalism,”* 32 IND. L. REV. 1 (1998) (introducing a symposium issue on “New Federalism”).

107. Many authors have made arguments in favor of greater state responsibility over policy issues. See, e.g., John D. Blum, *Overcoming Managed Care Regulatory Chaos Through a Restructured Federalism*, 11 HEALTH MATRIX 327, 339–44 (2001) (calling for greater state control in some areas of health care policy while favoring federal control over other areas); Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553, 555–59 (2001) (criticizing the public choice justification for federal regulation in environmental policy and suggesting that state-level regulation may be more responsive to environmental concerns than federal-level regulations). For commentary critical of trends towards expanded federalism, see Daniel H. Cole & Carol S. Comer, *Rhetoric, Reality, and the Law of Unfunded Federal Mandates*, 8 STAN. L. & POL’Y REV. 103, 110 (1997) (arguing that state and local governments have largely based their complaints about unfunded mandates on myths about their costs, though reserving judgment about the ultimate wisdom of the Unfunded Mandates Reform Act); Tracy A. Kaye, *Show Me the Money: Congressional Limitations on State Tax Authority*, 35 HARV. J. ON LEGIS. 149, 150–60 (1998) (criticizing “devolution” as inadequately taking into account the disparities in state resources for dealing with policy problems); Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341, 2414–15 (1996) (arguing for revised and more effective federal regulatory approaches to the problem of interstate environmental externalities). See generally DAVID L. SHAPIRO, *FEDERALISM: A DIALOGUE* (1995) (providing an extended discussion of the ongoing policy debates between proponents of national control and state control, albeit before the 1996 acts were passed).

108. See David J. Kennedy, *Due Process in a Privatized Welfare System*, 64 BROOK. L. REV. 231, 253–54 (1998); CONTRACT WITH AMERICA, *supra* note 96, at 125. But see *infra* notes 111–18 and accompanying text (discussing recent legislation sponsored by the Republican Party and passed by Congress that broadened federal regulation of corporate governance and set national standards for education).

especially those of international concern,¹⁰⁹ there are areas of policy in which proponents of state action have prevailed since 1996 and in which they may continue to influence political debates.¹¹⁰

Notably, however, the Republican Party has become increasingly willing to enact federal laws that preempt state laws, as the Party's control over federal legislation has increased, even in areas of traditional state authority such as education. For example, the No Child Left Behind Act of 2001¹¹¹ gives the U.S. Department of Education broad new authority over quality controls in state education policy.¹¹² In addition, the Sarbanes-Oxley Act of 2002¹¹³ creates expansive federal restrictions on executive compensation and furthers existing federal regulatory controls over corporate governance.¹¹⁴ Like the No Child Left Behind Act, the Sarbanes-Oxley Act enacts a single, inflexible federal standard¹¹⁵ that may have been ineffectively drafted and, partly as a result, overbroad.¹¹⁶ The

109. See Barry Friedman, Symposium, *The Law and Economics of Federalism: Valuing Federalism*, 82 MINN. L. REV. 317, 369–70 (1997) (noting that the doctrinal changes mirror what is happening in the nation and the world at large).

110. See *id.* at 368 (noting recent devolution trends). In a classic article on federalism, Professor Herbert Wechsler argues that the legislative process creates important safeguards for federalism concerns and that the concentrated focus of the academic legal community on the U.S. Supreme Court tends to deemphasize the legislative role in the defense of federalism. Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543, 543–44 (1954). The decentralization-inclined legislation of the 1990s, reinvigorating the interests of the states in matters of local policy, would appear to support his claim. Some Supreme Court Justices expressed support for Professor Wechsler's theory. See *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 565 n.9 (1985) (Powell, J., dissenting). It appears, however, that the current Court has faith in process federalism in light of current decisions. See *infra* notes 136–42 and accompanying text. See generally Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485, 1528 (1994) (arguing that party politics is a key instigator of process federalism, though refuting Wechsler's explanations in the article). But see Marshall, *supra* note 97, at 147–49 (questioning the validity of Professor Wechsler's predictions).

111. Pub. L. No. 107-110, 115 Stat. 1425 (codified as amended in scattered sections of 20 U.S.C.).

112. See Scott F. Johnson, *Reexamining Rowley: A New Focus in Special Education Law*, 2003 BYU EDUC. & L.J. 561, 574–75.

113. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

114. See Kathryn Stewart Lehman, Recent Development, *Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 81 N.C. L. REV. 2115, 2117–18 (2003) (illustrating the legislative intent of the Act contrasted against its shortfalls).

115. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 IOWA J. CORP. L. 441, 443–44 (2003) (referring to the act as a one-size-fits-all policy that threatens to deter qualified directors, thus further exposing investors).

116. Lehman, *supra* note 114, at 2117–18 (critiquing the legislation as overbroad and ineffectively drafted); see also *id.* at 2121–31 (detailing ambiguities in the statute regarding

fact that the legislation received overwhelmingly bipartisan support¹¹⁷ reinforces the notion that, even for members of Congress who espouse federalism in theory, the power of the Supremacy Clause is an alluring siren.¹¹⁸ Nevertheless, while federal control over policy priorities is hardly a dead letter,¹¹⁹ decentralization continues to be a popular governing philosophy¹²⁰ for a party that is currently in control of Congress, the presidency, and a majority of the governor's mansions.¹²¹ The increase in responsibility at the state level of government, therefore, adds to the need for flexibility in the state's system of finance. Regardless of what the optimal level of taxation is for the state and federal levels of government, with responsibility over policy objectives comes a need for budgetary options capable of meeting those objectives.¹²² Even if one argues that the tax level should not change, such that more discretionary programs should be cut to fund the more long-term and constant programs cited above, the enhanced need for flexibility remains. In fact, because economic

director and executive compensation restrictions).

117. *Id.* at 2120.

118. See Marshall, *supra* note 97, at 141–44 (noting what legislation federalism proponents supported that did and did not resonate with the principles of federalism). Professor Marshall asserts that the support an item of federal legislation receives is generally dependent on its policy substance, not on whether its implementation will occur at the appropriate level of government. *Id.* at 144.

119. See *Bush Priorities Stay Jammed in Congress*, WASH. POST, Oct. 26, 2003, at F2 (reporting that a Republican-sponsored bill to require most class actions to be filed in federal court failed by a single vote in the U.S. Senate); Jan Crawford Greenberg, *GOP Renews Attack on Malpractice Awards: Republicans Seeking Limits on Medical Malpractice Judgments See Tort Reform as Potent Political Weapon for the 2004 Campaign*, CHI. TRIB., Sept. 19, 2003, § 1, at 1 (reporting that the Republican Party remains committed to federal medical malpractice damage caps).

120. See Carl Hulse, *Passage Unlikely for Separate Bill on Electrical Grid*, N.Y. TIMES, Aug. 19, 2003, at A1 (reporting that the Republican Party favors market-based solutions that do not preempt state laws in the area of electricity regulation); Michael Janofsky, *U.S.-Utah Land Accord Incites Unlikely Critics*, N.Y. TIMES, May 23, 2003, at A18 (reporting on Republican-led initiatives to provide for greater local control over federal lands); Bob Kemper, *Partisan Clash in Congress Clouds Head Start's Future: Bush, Democrats in Bitter Impasse*, CHI. TRIB., Sept. 30, 2003, § 1, at 15 (reporting on the Republican Party's effort to give states greater control over Head Start).

121. Brooke Donald, *GOP Showed National Gains, Controlling Congress*, MILWAUKEE J. SENTINEL, Dec. 29, 2002, at 2J; Melanie Eversley, *GOP Hears a Mandate; National Victories Kick Republican Agenda Into High Gear*, ATLANTA J. & CONST., Nov. 7, 2002, at 1A.

122. See Bent E. Sorensen & Oved Yosah, *Is State Fiscal Policy Asymmetric Over the Business Cycle?*, in ECONOMIC REVIEW—FEDERAL RESERVE BANK OF KANSAS CITY, Third Quarter 2001, at 48 (arguing that balanced budget rules limit policy flexibility and exacerbate the business cycle). *But see id.* at 49 (arguing that “political ‘sacred cows’” can grow to inefficient levels during economic expansions and be unpopular to cut during downturns).

downturns often create enhanced needs, such as in the case of the state's unemployment insurance program¹²³ and the greater volatility resulting from the trend toward globally open markets,¹²⁴ the case for government services is at its greatest during downturns and at its least during good times. Unless one posits that the legislature can predict when downturns will come and how large they will be, such that government saving will solve the planning problem, there is a strong case for financial flexibility across the business cycle that can adapt to changes as they arise. Further, political process federalism involves state and federal legislators making decisions about the optimal balance between state and federal responsibilities.¹²⁵ Arguments for decentralization in policy matters are, plainly, directly dependent on the capacity of the more localized governments to achieve policy goals.¹²⁶

B. Recent Judicial Trends

While legislative law and policymaking have significantly impacted state budgets in recent years, so too have judicial decisions. In North Carolina's state budget, education is the two-ton gorilla. In recent Supreme Court of North Carolina jurisprudence, the same might be said about *Leandro v. State*.¹²⁷ Decided in 1997, the decision added to a number of path-breaking state supreme court decisions around the nation interpreting state constitutional guarantees of public education to contain an implicit minimum standard requirement.¹²⁸ The notion that the state's constitutional guarantee of public education¹²⁹ might implicate judicial review of the legislature's solution potentially foretells a whole new era of litigation over public education. The Supreme Court of North Carolina, in an opinion written by Chief Justice Burley Mitchell, adopted a four-prong test for determining what constitutes a "sound basic education," thus

123. See *supra* notes 77–83 and accompanying text.

124. See *supra* notes 69–76 and accompanying text.

125. See *supra* notes 97–98, 107–10 and accompanying text.

126. Cf. Dale Bails & Margie A. Tieslau, *The Impact of Fiscal Constitutions on State and Local Expenditures*, 20 CATO J. 255, 271 (2000) ("[T]he institutional framework within which policy spending decisions are made clearly is influenced by the presence of certain fiscal discipline mechanisms."), available at <http://www.cato.org/pubs/journal/cj20n2/cj20n2-7.pdf>.

127. 346 N.C. 336, 488 S.E.2d 249 (1997).

128. See Margaret Rose Westbrook, Comment, *School Finance Litigation Comes to North Carolina*, 73 N.C. L. REV. 2123, 2125–34 (1995) (reviewing several cases involving school finance litigation).

129. N.C. CONST. art. IX, § 2(1) (guaranteeing "a general and uniform system of free public schools . . . wherein equal opportunities shall be provided for all students").

holding:

For purposes of our Constitution, a “sound basic education” is one that will provide the student with at least: (1) sufficient ability to read, write, and speak the English language and a sufficient knowledge of fundamental mathematics and physical science to enable the student to function in a complex and rapidly changing society; (2) sufficient fundamental knowledge of geography, history, and basic economic and political systems to enable the student to make informed choices with regard to issues that affect the student personally or affect the student’s community, state, and nation; (3) sufficient academic and vocational skills to enable the student to successfully engage in post-secondary education or vocational training; and (4) sufficient academic and vocational skills to enable the student to compete on an equal basis with others in further formal education or gainful employment in contemporary society.¹³⁰

This guarantee will probably require substantial attention and funding in order to ensure compliance and minimize litigation associated with the *Leandro* standard.¹³¹ Further, the new “sound basic education” requirement is just as inflexible as the balanced budget provision of the constitution—it makes no exceptions for revenue shortfalls or economic downturns. This ruling is hardly unprecedented. From 1971 to 1997, twelve state supreme courts held that their respective states failed to meet the requirements of their state constitutions’ education clauses.¹³² All state constitutions

130. *Leandro*, 346 N.C. at 347, 488 S.E.2d at 255.

131. See generally Andrew Broy, Comment, *Charter Schools and Educational Reform: How State Constitutional Challenges Will Alter Charter School Legislation*, 79 N.C. L. REV. 493 (2001) (discussing the impact of *Leandro* on the charter school movement); Kelly Thompson Cochran, Comment, *Beyond School Financing: Defining the Constitutional Right to an Adequate Education*, 78 N.C. L. REV. 399 (2000) (discussing jurisprudence in the area of constitutional guarantees of education); Westbrook, *supra* note 128, at 2147–79 (previewing the *Leandro* litigation).

132. See ANNA LUKEMEYER, COURTS AS POLICYMAKERS: SCHOOL FINANCE REFORM LITIGATION 52–53 (2003) (listing the ten decisions from 1971 to 1996 of that disposition); see also *Roosevelt Elementary Sch. Dist. No. 66 v. Bishop*, 877 P.2d 806, 808 (Ariz. 1994) (holding that the financing scheme for public education violates the constitutional requirement to provide a public education); *DuPree v. Alma Sch. Dist. No. 30*, 651 S.W.2d 90, 95 (Ark. 1983) (same); *Horton v. Meskill*, 376 A.2d 359, 374 (Conn. 1977) (same); *Rose v. Council for Better Educ., Inc.*, 790 S.W.2d 186, 189 (Ky. 1989) (same); *McDuffy v. Sec’y of the Executive Office of Educ.*, 615 N.E.2d 516, 517–18 (Mass. 1993) (same); *Helena Elementary Sch. Dist. No. 1 v. Montana*, 769 P.2d 684, 690 (Mont. 1990) (same); *Abbott v. Burke*, 575 A.2d 359, 363 (N.J. 1990) (same); *Edgewood Indep. Sch. Dist. v. Kirby*, 777 S.W.2d 391, 392 (Tex. 1989) (same); *Campbell County Sch. Dist. v. Wyoming*, 907 P.2d 1238, 1244 (Wyo. 1995) (same). Lukemeyer incorrectly refers to *School Administrative District No. 1 v. Commissioner* as a decision in which the court ruled

presently include some obligation for the state to provide for public education,¹³³ so the constitutional gravity of education spending is a universal feature of state budgetary responsibilities.

At the federal level, several trends in United States Supreme Court jurisprudence place further responsibilities on state governments. In the past decade, there has been a slow but steady trend towards curbing the power of the federal government under the limitations of the Interstate Commerce Clause¹³⁴ and the Tenth Amendment.¹³⁵ In the 1992 case *New York v. United States*,¹³⁶ the Court for the first time declared a federal act unconstitutional as impermissibly appropriating state power for its own regulatory purposes.¹³⁷ This newly emboldened defense of state sovereignty soon found expression in a revived Interstate Commerce Clause, which the Supreme Court in *United States v. Lopez*¹³⁸ held did not grant Congress the power to prohibit guns on the campuses of public schools.¹³⁹ While the impact of these doctrines remains unclear,¹⁴⁰ the

in favor of the plaintiffs' challenge to the constitutionality of the state education system. See LUKEMEYER, *supra*, at 53; Sch. Admin. Dist. No. 1 v. Commissioner, 659 A.2d 854, 858 (Me. 1995). In 1997, the Supreme Court of North Carolina, see *Leandro v. State*, 346 N.C. 336, 347, 488 S.E.2d 249, 255 (1997), and the Ohio Supreme Court, see *Derolph v. Ohio*, 677 N.E.2d 733, 737 (Ohio 1996), also held that their respective states' education systems did not satisfy constitutional requirements to provide for public education. Thus, from 1971 to 1997, twelve state high courts found their school systems constitutionally deficient.

133. See LUKEMEYER, *supra* note 132, at 6.

134. U.S. CONST. art. I, § 8(3).

135. *Id.* amend. X.

136. 505 U.S. 144 (1992).

137. See Paul Lund, *The Decline of Federal Common Law*, 76 B.U. L. REV. 895, 895–96 (1996).

138. 514 U.S. 549 (1995); see Daniel A. Farber, Symposium, *Reflections on United States v. Lopez: The Constitution's Forgotten Cover Letter: An Essay on the New Federalism and the Original Understanding*, 94 MICH. L. REV. 614, 622–26 (1995) (analyzing in detail the U.S. Supreme Court's doctrinal shift in *Lopez*).

139. See Farber, *supra* note 138, at 642–43. See generally Judge Louis H. Pollak, Symposium, *Reflections on United States v. Lopez*, 94 MICH. L. REV. 533 (1995) (analyzing the implications of the case).

140. See *United States v. Morrison*, 529 U.S. 598, 627 (2000) (striking down the Violence Against Women Act of 1994 as beyond Congress's power under the Interstate Commerce Clause); *United States v. Alfonzo Coward*, 151 F. Supp. 2d 544, 554 (E.D. Pa. 2001), *remanded* 296 F.3d 176 (3d Cir. 2002) (sustaining an Interstate Commerce Clause challenge to federal gun law); see also Gordon G. Young, *The Significance of Border Crossings: Lopez, Morrison, and the Fate of Congressional Power to Regulate Goods, and Transactions Connected with Them, Based on Prior Passage through Interstate Commerce*, 61 MD. L. REV. 177, 178–80 (2002) (arguing that not all instances of interstate border crossings give the federal government power to regulate under the Interstate Commerce Clause). *Morrison* and *Alfonzo Coward* illustrate that the Interstate Commerce Clause challenges are certainly viable, but the specific foundations that they draw will only

philosophical posture that they take expands the prerogatives of the states under the U.S. Constitution in the modern governing era. Tenth Amendment protections are slowly but steadily being fleshed out in the federal court system.¹⁴¹ Congress's Interstate Commerce Clause power has likewise become a bit more unstable in both Supreme Court and lower federal court jurisprudence.¹⁴² These trends have not developed enough to impact the state budgets, though they suggest that states may have greater policy responsibility in the future, given the glacially advancing limits on congressional power.¹⁴³ Thus, as the states gradually obtain more responsibility to make policy decisions, there will be correspondingly greater demands on the state budget.

Moreover, a quieter but perhaps much more significant trend has occurred within the realm of federal court power under the current Supreme Court. In a line of cases delineating the limits within which federal courts can enact rules, the Supreme Court repeatedly directed the federal courts to defer to state law as opposed to drawing from federal jurisprudence, absent a clear grant of power by the national government.¹⁴⁴ The states have thus been given significantly greater responsibility to fill in the policy gaps left by federal law in recent years.¹⁴⁵

The significance of these legal trends for the optimal financial structure of state government is not that tax levels need to change, but more broadly that financial flexibility is a necessary corollary to managing that enhanced responsibility.¹⁴⁶ This assertion is, as contended in the previous Section on legislative approaches to

become clear as the courts apply these doctrines in subsequent cases. See J. Mitchell Pickerill, *Leveraging Federalism: The Real Meaning of the Rehnquist Court's Federalism Jurisprudence for States*, 66 ALB. L. REV. 823, 826 (2003).

141. See Lund, *supra* note 137, at 896 n.6 (referencing U.S. Supreme Court and circuit court cases fleshing out Tenth Amendment protections). See generally George J. Thomas, *The Brady Act, the Tenth Amendment, and America's Gun Cult*, 30 UWLA L. REV. 23 (1999) (analyzing further Tenth Amendment usages in the context of gun control and the Brady Act); Michael Van Arsdall, Comment, *Enforcing the Enforcement Clause: City of Boerne v. Flores Chips Away at Congressional Power*, 48 CATH. U. L. REV. 249, 291-92 (1998) (discussing a case that, in the opinion of the author, is consonant with Tenth Amendment protections in the course of striking down federal law). Professor Nagel assures us, however, that the sky is not falling, and that the Rehnquist Court has not embarked on a grand scheme to hamstring the federal government with the Tenth Amendment. NAGEL, *supra* note 92, at 38-39.

142. See *supra* notes 138-39.

143. See *supra* note 136-40.

144. See Lund, *supra* note 137, at 895-901.

145. See *id.* at 900-01.

146. See Sorensen & Yosah, *supra* note 122, at 48.

federalism, not merely reactive. Rather, the capability of the states and their receptiveness to take on responsibility in the modern American governmental system is also a relevant factor in judicial protections of their role. If states remain hamstrung by restrictive financing options, the argument for their policy role being protected by constitutional doctrine as well as statutory interpretation of the scope of federal administrative power is substantially weakened.¹⁴⁷ In that sense, the financial strength of the states is an integral part of the ongoing debate over the virtues of federalism and localized control of decision-making power.

While none of these decisions, save perhaps *Leandro v. State*, is likely to spawn fiscal disaster, in concert they create an important new set of long-term responsibilities for state governments. The federal court decisions also resonate with political rhetoric of the last decade that extols the virtues of acting at the state—as opposed to the federal—level.¹⁴⁸ While *Leandro* applies only to North Carolina, a growing number of state supreme courts have come to similar conclusions with respect to their constitutional provisions for education under state governments' wings.¹⁴⁹ The federal court

147. See *McCulloch v. Maryland*, 17 U.S. 316, 415 (holding, in its definition of the scope of federal legislative power, that the “constitution [was] intended to endure for ages to come, and, consequently, to be adapted to the various crises of human affairs”); see also Lino A. Graglia, *Revitalizing Democracy*, 24 HARV. J.L. & PUB. POL’Y 165, 166–67 (2000) (arguing that doctrinal evolution in constitutional approaches to federalism should embody notions of a “living Constitution” and adaptation to “new circumstances”). Professor Graglia argues that highly deferential review of congressional assertions of federal power, in which the courts defer to congressional judgment on the scope of its constitutional power, is worse than no review at all because it suggests to the Congress that its policy decisions are constitutionally sound. *Id.* at 167. However, he prefers political process federalism to judicially monitored federalism. *Id.* Cf. Morton J. Horwitz, Foreword, *The Constitution of Change: Legal Fundamentality Without Fundamentalism*, 107 HARV. L. REV. 32, 51–56 (1993) (providing a historical overview of legal theorists and judges who have embraced the notion of a living Constitution that adapts to the needs and practical abilities of governments); William Jeffrey, Jr., *The Constitution: “A Firm National Government”*, in HOW FEDERAL IS THE CONSTITUTION? 16, 27–30 (Robert A. Goldwin & William A. Schambra eds., 1987) (arguing that there are few limits on federal power); David M. Kennedy, *Federalism and the Force of History*, in HOW FEDERAL IS THE CONSTITUTION?, *supra*, at 67–83 (Robert A. Goldwin & William A. Schambra eds., 1987) (illustrating the impact of economic and political change on evolving constitutional approaches to federalism). But see Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 3, 38 (Amy Gutmann ed., 1997) (arguing that constitutional interpretation must be firmly rooted in the original understanding of the text, not in evolving notions that take practical impacts of rulings into consideration).

148. See *infra* Part III.A.

149. See *Rose v. Council for Better Educ., Inc.*, 790 S.W.2d 186, 211 (Ky. 1989)

decisions limiting the power of the national government, of course, impact all states as actors in the federal system. Thus, these trends have broad application across the country.

C. *New Economic Realities*

Bridging the fiscal deficits of 2001–02 proved to be a two-year nightmare for both the governor and the General Assembly.¹⁵⁰ In the words of the Raleigh-based *News and Observer*, “Lawmakers called it the worst budget crisis since the Great Depression.”¹⁵¹ The General Assembly had to make up a nearly \$2 billion shortfall, given the ongoing financial obligations and policy priorities of the state and sharply declining revenues.¹⁵² The severity of the recession in North Carolina exceeded that of many other states, given the sharp declines in manufacturing and tobacco, traditionally important economic activities for the state.¹⁵³ The number of skilled jobs available in the high-paying technology sector also declined.¹⁵⁴

North Carolina’s experience was hardly unique. Throughout state legislatures across the nation, lawmakers faced similar dilemmas of revenue shortfalls and balanced budget requirements pinching the budget process.¹⁵⁵ This occurred despite consistent state budget

(holding that the state’s common schools must be adequately funded, substantially uniform, and that every child be afforded equal opportunity); *Claremont Sch. Dist. v. Governor*, 635 A.2d 1375, 1376 (N.H. 1993) (holding that the State has a duty to provide an education to every educable child in public school); *Bd. of Educ. v. Nyquist*, 439 N.E.2d 359, 368–69 (N.Y. 1982) (holding that the state constitution requires only minimal acceptable facilities and services, not equality); *Seattle Sch. Dist. No. 1 v. State*, 585 P.2d 71, 76–77 (Wash. 1978) (en banc) (holding that the State has a mandatory duty to make ample provision for basic education of all resident children through a uniform system); *Alabama Coalition for Equity, Inc. v. Hunt*, No. CV-90-883-R (Ala. Cir. Ct. 1993), *reprinted in* Opinion of the Justices No. 338, 624 So.2d 107, 165–66 (Ala. 1993) (holding that the State must provide all school-age children with substantially equitable and adequate educational opportunities).

150. See Wade Rawlins, *Budget Woes Not Over*, NEWS & OBSERVER (Raleigh, N.C.), Sept. 21, 2002, at A1; Wade Rawlins, *Easley Seeks to Raise Sales Tax*, NEWS & OBSERVER (Raleigh, N.C.), Aug. 17, 2001, at A1.

151. Kane, *supra* note 43.

152. *Id.*

153. Meredith Barkley, *Charlotte Jobless Spike Highest*, GREENSBORO NEWS & RECORD, June 29, 2001, at B10; Amy Martinez, *State’s Jobless Rate Rises Substantially*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 25, 2003, at D1.

154. Martinez, *supra* note 153.

155. See NAT’L ASS’N OF STATE BUDGET OFFICERS, THE FISCAL SURVEY OF STATES 2–3 (May 2002), available at <http://www.nasbo.org/Publications/fiscsurv/may2002fiscalsurvey.pdf>; Rob Christensen & Amy Gardner, *More Red Ink*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 24, 2002, at A1 (explaining that Virginia, Georgia, and South Carolina, for example, have similar budget shortfalls); see also BUDGET SHORTFALLS, *supra* note 48, at 1–2 (summarizing the financial difficulties of the states in

surpluses from only a few years before.¹⁵⁶ However, one other major economic shock was entirely unique to the state—Hurricane Floyd of 1999.¹⁵⁷ In addition to creating a supply-side shock to the eastern half of the state's tax base through extensive crop damage and flooding,¹⁵⁸ the natural disaster also increased fiscal outlays to help victims cope with loss.¹⁵⁹ In the process, the State was forced to drain the rainy day fund, a mechanism designed to help the State cope with budget shortfalls through savings rather than financing.¹⁶⁰ In this respect, North Carolina's recent economic experience illustrates a fundamental shortcoming of the balanced budget requirement. Even when the state enjoys an unprecedented economic boom, as it did in the 1990s, and saves during that time in anticipation of future budgetary needs, a major hurricane plus a recession can easily wipe out this attempted provision for the future. Thus, to no small extent the current budget crisis was caused not by poor fiscal planning but by a constitutional straitjacket that can constrict even responsible lawmakers. This recent experience shows an intractable problem with relying on the rainy day fund mechanism for smoothing out financial resources across time, where recessions, natural disasters, and fiscal needs fluctuate. The rainy day fund combined with the balanced budget rule, while it has the advantage of requiring the highest caliber of fiscal discipline, errantly presumes that budget planners can predict the future¹⁶¹ in addition to relying precariously

fiscal year 2002).

156. W. Mark Crain and James C. Miller III, *Budget Process and Spending Growth*, 31 WM. & MARY L. REV. 1021, 1021 (1990).

157. See 2000 CAFR, *supra* note 69, at 9.

158. John Wagner, *Hunt Likely to Call Special Session*, NEWS & OBSERVER (Raleigh, N.C.), Oct. 14, 1999, at A1.

159. See 2000 CAFR, *supra* note 69, at 9 (reporting that the General Assembly allocated \$836.6 million for flood relief in a special session devoted to the disaster).

160. John Wagner, *Don't Fret About Cuts, Hunt Aides Say*, NEWS & OBSERVER (Raleigh, N.C.), Dec. 22, 1999, at A1.

161. See Stephanie Schmitt-Grohé & Martín Uribe, *Balanced-Budget Rules, Distortionary Taxes, and Aggregate Instability*, 105 J. POL. ECON. 976, 977 (1997). The authors present an economic model that demonstrates that "under a balanced-budget rule the rational expectations equilibrium can be indeterminate." *Id.* In other words, assuming that lawmakers exhibit rational expectations behavior, where they predict the future based on the best available knowledge, the balanced budget rule itself creates economic indeterminacy. See *id.* at 982–86 (modeling the point of indeterminacy in the model). Relaxing the assumption of rational expectations by introducing self-serving motivations and imperfect information within the legislature would increase the indeterminacy of their model. Self-serving motivations, for example, would include overspending during booms as the result of political pressures, and imperfect information is the common phenomenon of not knowing what the future macroeconomic trend will be.

on a particularly austere level of lawmaker altruism.¹⁶² Financial instruments that allow lawmakers sufficient flexibility to deal with problems more accurately as they arise, rather than engage in guesswork as to what the future will hold, would improve the budgetary climate substantially. The thesis of this Comment is that coupling increased flexibility with constitutional restrictions on spending would be more consistent with the practical realities of the budget process.¹⁶³

The resulting policy choices have been harsh. While social service and crime problems tend to increase during times of economic hardship, the State was forced to cut social services targeting them in order to close the gap.¹⁶⁴ Services that were considered to be less essential were cut by a much greater proportion.¹⁶⁵ Spending on the environment and natural resources, for example, was cut by nine percent in the 2002–03 budget.¹⁶⁶ Likewise, the pension plans of state employees and higher education tuition rates helped shoulder a significant share of the burden.¹⁶⁷

Lastly, a note about the history of revenue sources further illustrates the changed circumstances. In 1868, when the constitutionally mandated balanced budget originated, the primary source of revenue for state and local governments was the property tax.¹⁶⁸ In 1900, for example, seventy-seven percent of combined state and local revenues came from the property tax.¹⁶⁹ This trend continued until the 1930s, by which time the State had weaned itself off the property tax.¹⁷⁰ During this time period, the State also began funding local governmental initiatives at a much greater rate.¹⁷¹ The property tax has historically been administered almost exclusively at

162. See Sorensen & Yosah, *supra* note 122, at 49 (noting the tendency of politicians to overspend during booms). This point is a particularly important argument against relaxing the balanced budget rule because it suggests that lawmakers can overspend during booms and then rely on borrowing to get through revenue downturns. This is a key reason why relaxing the balanced budget rule should be accompanied by a companion restriction in spending growth in order to maximize flexibility while not encouraging the government to grow beyond its efficient size.

163. See *infra* Part III.D.

164. See ELAINE MEJIA, *THE FINAL BUDGET AGREEMENT: LAST, BUT NOT LEAST?* 3 (2003).

165. Richard Sutch, *Has Social Spending Grown Out of Control?*, CHALLENGE, May-June 1996, at 11 (noting the countercyclical nature of social spending).

166. *Id.*

167. *Id.* at 4.

168. See STATE AND LOCAL, *supra* note 11, at 8.

169. *Id.*

170. *Id.*

171. *Id.* at 8–9.

the local level,¹⁷² and as trends toward state implementation of services increased, the locally assessed property tax became a less attractive option.¹⁷³ The significance of the property tax is that, as a revenue source, it is very stable.¹⁷⁴ Property values are assessed only occasionally, so the taxes that flow from them remain relatively constant amid economic fluctuations. Thus, revenue stream instability was not nearly the concern that it is today, given the State's dependence on sales tax and income tax collections.¹⁷⁵

D. Unsolved Policy Issues Facing the States

This Comment does not argue for a particular level of taxation; rather, it suggests that trends in law and policy call for a constitutional modification of the budget process. However, some reference to significant and progressing policy shortcomings is necessary to illustrate the ongoing pressures on the modern state budget, legal obligations of the state, and the importance of maintaining a constant expenditure stream that is more independent of economic and demographic fluctuations.

Fundamental issues of legal rights as defended by the judicial branch form an important starting point. In his 2001 State of the Judiciary address, newly-elected Chief Justice I. Beverly Lake suggested that the existing funding level was inadequate for the judiciary to meet the legal needs of the state.¹⁷⁶ Framing the problem as one of constitutional gravity, Chief Justice Lake asserted that the existing budget for the state court system "has not been able to meet adequately our constitutional responsibilities and expand our services as demanded by our growing population."¹⁷⁷ In particular, he lamented the impact of judicial shortages on children through juvenile court, domestic dispute adjudication, and domestic violence:

I want to stress to you that each and every one of these children is just as important to North Carolina as any child in our public schools or in Smart Start, and I submit to you, they are much

172. See JAMES A. MAXWELL, *FINANCING STATE AND LOCAL GOVERNMENTS* 126-27 (rev. ed. 1969).

173. *Id.*

174. *Id.* at 128, 133.

175. COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 2 (explaining North Carolina's reliance on income and sales tax revenues).

176. Chief Justice I. Beverly Lake, Jr., State of the Judiciary Address 2 (2001), available at <http://www.aoc.state.nc.us/www/copyright/aoc/speeches/lakesoj.pdf>.

177. *Id.*; see also Matthew Eisley, *Judiciary Funding Urged*, NEWS & OBSERVER (Raleigh, N.C.), Mar. 27, 2001, at A3 (reporting on the Chief Justice's address to the General Assembly).

more at risk We must not let them down by failing to fund their future.¹⁷⁸

One of the important tools of the budget-cutter in lean years is not filling job vacancies until the fiscal shortage abates. Shortages in judicial staffing, the Chief Justice lamented, not only decrease the confidence that the public has in the court system and increase the frustration associated with it, but they also implicate basic issues of efficiency.¹⁷⁹ For example, failure to adequately staff the courts with court reporters sometimes results in increased confusion, delay, and expense to the litigants.¹⁸⁰

On the criminal justice side, prisoners' rights continue to be at risk. Given that they are in the full custody of the State, the State has substantial responsibilities to ensure prisoners' constitutionally protected safety.¹⁸¹ In particular, the state's older jails that lack sprinkler systems and centrally controlled jail doors may be of significantly greater risk to inmates in the event of a fire.¹⁸² In this respect, judicial decisions specifying the constitutional rights of prisoners¹⁸³ begin to push against the state constitution's mandate for a balanced budget. Like *Leandro's* requirement that the North Carolina General Assembly provide a "sound basic education,"¹⁸⁴ conflicting state constitutional pressures may indeed invite increased litigation over the constitutionality of North Carolina budgets, a situation that is not without precedent in other states.¹⁸⁵

178. Lake, *supra* note 176, at 5.

179. *See id.* at 3, 5.

180. *See id.* at 3. In the words of Chief Justice Lake:

The damage from this kind of breakdown is measured not just in the cost of wasted time and resources, but also in the enormous amount of bad will and hostility generated and directed toward our court system by all those citizens who have been made to suffer the wasteful loss of valuable time out of their lives

The cost of a court reporter is minimal compared to this.

Id.

181. *See generally* Hope v. Pelzer, 536 U.S. 730 (2002) (upholding the importance of humane treatment of prisoners and safe jail conditions as implicated in the Cruel and Unusual Punishment Clause).

182. Andrea Weigl & Karin Schill Rives, *Older County Jails Lack Sprinklers, Remote Control Doors*, NEWS & OBSERVER (Raleigh, N.C.), May 6, 2002, at A10.

183. Article I, section 27, of the North Carolina Constitution echoes the U.S. Constitution's prohibition on cruel and unusual punishments. *See* U.S. CONST. amend. VIII; N.C. CONST. art. I, § 27.

184. *Leandro v. State*, 346 N.C. 336, 353, 488 S.E.2d 249, 258 (1997).

185. *See generally* Darryl B. Simko, *Of Pensions, State Constitutional Contract Protection, and Fiscal Restraint*, 69 TEMP. L. REV. 1059, 1064-71 (1996) (analyzing the recent experience of Michigan, New York, and Illinois in terms of the conflicting duties of the legislature to balance the budget while honoring state pension commitments and contracts). Raising pension funds to balance the budget, which has been one solution of

Another area of concern is more abstract: the general tendency of policymakers to resort to short-term fixes that impose long-term costs when faced with budget pressures.¹⁸⁶ In a sense, this practice is itself a kind of borrowing. Bad policy in the present and greater costs in the future are the heavy prices to pay for short-term savings. A typical example of this trade-off is a reduction in social spending that leads to increased crime in the future, which in turn translates to higher court costs and more prisoners.¹⁸⁷ This may potentially be a net fiscal loss for the state, even without considering the negative impact of crime in society and the greatly decreased economic productivity of convicts during incarceration.

These dilemmas, brewing below the surface at present, will eventually surface and have to be faced regardless of the fact that budget makers in a recession are more concerned with bridging the existing fiscal gap than with solving new problems. The General Assembly can, of course, design short-term fixes when fiscal times are tough. In a worst case scenario, these fixes would become the subject of state constitutional litigation that would begin to question whether the state constitution is itself internally inconsistent—requiring the General Assembly to provide a sound basic education for all students, honor the contractual obligations to state pension plans, protect prisoners' rights, and maintain a court system that does not unconstitutionally delay criminal and civil trials, while still preserving a balanced budget.¹⁸⁸

While this scenario may sound more like a clever thought experiment than a realistic possibility, one state supreme court has

North Carolina's General Assembly, may also give rise to a takings claim if the pension funds are to be regarded as private property. *See id.*

186. *See* Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 643–44 (1995) (outlining the standard public choice theory of how politicians maximize short-term gains, sometimes at the expense of the long-term public interest).

187. *See* Amy Gardner, *Service Groups Fear Budget Ax*, NEWS & OBSERVER (Raleigh, N.C.), Apr. 22, 2002, at A1 (reporting on the cuts in grants given to non-profits and the possible long-term criminal costs associated with the cuts); *see also* John J. Donohue III & Peter Siegelman, *Allocating Resources Among Prisons and Social Programs in the Battle Against Crime*, 27 J. LEGAL STUD. 1, 32–35 (1998) (describing the trade-off between current social spending and future spending on crime prevention). Professors Donohue and Siegelman make an empirical argument that targeted social spending towards at-risk youth will yield lower long-term costs to the state for programs like Job Corps, but that other programs like Head Start cannot be justified under a crime prevention rationale. *Id.* at 35.

188. *But see Leandro*, 346 N.C. at 352, 488 S.E.2d at 258 (“It is axiomatic that the terms or requirements of a constitution cannot be in violation of the same constitution—a constitution cannot violate itself.”).

already handed down this legal bombshell. In *Guinn v. Legislature*,¹⁸⁹ the Nevada Supreme Court determined that the competing constitutional obligations on the state government were irreconcilable¹⁹⁰ and suspended the constitutional requirement of a two-thirds vote to increase taxes.¹⁹¹ Drawing a distinction between substantive requirements of the government and procedural requirements of the legislative process, the court held that the latter must yield when in conflict.¹⁹² Because the legislature and governor were unable to resolve the impasse over the budget, given the existing contractual obligations of the State, the constitutional mandate for “support and maintenance of the public schools,”¹⁹³ and the legislature’s inability to muster a supermajority to raise taxes, the court declared that the legislature was to proceed under simple majority rule.¹⁹⁴ Internal inconsistency in a constitution is quite literally the precipice that can threaten the very viability of a constitutional government, given its dependence on the constitution as the immutable first principle on which the government is founded.¹⁹⁵

III. MODERN ALTERNATIVES

A. *Approaches Taken by Other Governments*

Assuming now that there is a case for reconsidering the wisdom of the balanced budget mandate, what practical alternatives are available to policymakers? North Carolina’s budget requirements are relatively strict compared to other states’ balanced budget provisions. Some states merely require that the governor submit a balanced budget to the legislature.¹⁹⁶ Idaho¹⁹⁷ and Texas¹⁹⁸ do not compel the

189. 71 P.3d 1269 (en banc) (Nev. 2003), *reh’g dismissed, clarified* 76 P.3d 22 (Nev. 2003).

190. *Id.* at 1276.

191. *Id.* at 1275.

192. *Id.*

193. *Id.*

194. *Id.* at 1272.

195. See *People v. Anderson*, 493 P.2d 880, 886 (Cal. 1972) (“[W]herever possible we construe constitutional provisions in such a way as to reconcile potential conflict among provisions and give effect to each . . .”); *Guinn*, 71 P.3d at 1275; *Leandro v. State*, 346 N.C. 336, 352, 488 S.E.2d 249, 258 (1997) (“It is axiomatic that the terms or requirements of a constitution cannot be in violation of the same constitution—a constitution cannot violate itself.”); *Fino*, *supra* note 48, at 775 (discussing the financial crunch that states have suffered as a result of tax restrictions combined with spending mandates).

196. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, 1 BUDGET PROCESSES AND TAX SYSTEMS 6 (1993)

governor to submit a balanced budget but do require the legislature to pass a balanced budget, though the final deal between the executive and legislature need not be balanced.¹⁹⁹ Conversely, Kansas mandates that the governor and legislature both present balanced budgets, but does not impose a requirement that the final deal be balanced.²⁰⁰ Lastly, Vermont, now alone among the states, continues to impose no budgetary restrictions on lawmakers with respect to budget balancing.²⁰¹

There are many other differences in the details of these requirements across the country. For example, some states, such as Massachusetts,²⁰² Alabama,²⁰³ Alaska,²⁰⁴ and North Carolina,²⁰⁵

[hereinafter SIGNIFICANT FEATURES OF FISCAL FEDERALISM]. Examples of states that require that the governor submit a balanced budget and nothing further include California, New Hampshire, and Washington. *Id.* For more on state budget requirements, see Jerry W. Calvert, *The Popular Referendum Device and Equality of Voting Rights—How Minority Suspension of the Laws Subverts “One Person-One Vote” in the States*, 6 CORNELL J.L. & PUB. POL’Y 383, 395 (1997); GEN. ACCOUNTING OFFICE, BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT 10 (1993), at <http://archive.gao.gov/d44t15/148877.pdf> (on file with the North Carolina Law Review); see also NAT’L ASSOC. OF STATE BUDGET OFFICERS, BUDGET PROCESSES IN THE STATES 33–35 (2002) [hereinafter BUDGET PROCESSES IN THE STATES] (summarizing balanced budget requirements for all fifty states and Puerto Rico).

197. IDAHO CONST. art. VII, § 11.

198. TEX. CONST. art. III, § 49.

199. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 196, at 6.

200. See KAN. STAT. ANN. § 79-2927 (2002).

201. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 196, at 6.

202. MASS. CONST. art. LXII, §§ 2, 3. These sections provide the following restriction:
Section 2. The commonwealth may borrow money to repel invasion, suppress insurrection, defend the commonwealth, or to assist the United States in case of war, and may also borrow money in anticipation of receipts from taxes or other sources, such loan to be paid out of the revenue of the year in which it is created.
Section 3. In addition to the loans which may be contracted as before provided, the commonwealth may borrow money only by a vote, taken by the yeas and nays, of two-thirds of each house of the general court present and voting thereon.
The governor shall recommend to the general court the term for which any loan shall be contracted.

Id.; see also MASS. GEN. LAWS ch. 29, § 6E (2003) (regulating the budget balancing by statute); Opinion of Justices to Senate, 236 N.E.2d 523, 527 (Mass. 1968) (stating that borrowing by public authorities under the control of the executive branch does not violate the constitutional debt restriction).

203. ALA. CONST. art. XI, § 213, *amended by* ALA. CONST. amend. XXVI.

204. ALASKA CONST. art. IX, § 8 (“No state debt shall be contracted unless authorized by law for capital improvements or unless authorized by law for housing loans for veterans, and ratified by a majority of the qualified voters of the State who vote on the question.”).

205. N.C. CONST. art. V, § 3; see also *id.* art. III, § 5(3) (requiring the Governor to ensure that no actual fiscal deficit arises during the year).

require balanced budgets as a part of the constitutional charter, whereas Mississippi²⁰⁶ and Arkansas²⁰⁷ impose balanced budget requirements solely by statute.²⁰⁸ Further, some mechanisms are stronger than others. For example, Idaho's constitution requires a balanced budget, but apparently "there are no sanctions"²⁰⁹ for failing to balance the budget, as the legislature has over-appropriated budgets without successful challenge.²¹⁰ New York and Virginia do not have balanced budget requirements with respect to bill passage, but rather impose a requirement on the executive not to spend more than actual revenues.²¹¹

When a particular year's revenue projections fall short of the legislature's desired appropriations, there are two possible remedies for preserving a constant supply of governmental goods and services: spend the savings or borrow from the future. All states, including North Carolina,²¹² have provisions for saving when revenues exceed budgeted expenditures.²¹³ Virtually every state has a unique method of dealing with such situations, ranging from complete legislative discretion²¹⁴ to the automatic reversion of excesses to a reserve fund.²¹⁵ North Carolina falls somewhere in the middle; by default, 25% of the annual excesses go into the rainy day fund until they reach 5% of the general operations budget total for the year.²¹⁶ However, this mechanism is subject to the approval of the General Assembly²¹⁷ and the governor through the legislative process.²¹⁸

Eventually, however, shortfalls will occur. Just as few private

206. MISS. CODE ANN. §§ 27-103 to -139 (2003).

207. See ARK. CODE ANN. § 19-2-104 (1987) (mandating that state officials not spend more than their respective departments are appropriated). But cf. ARK. CONST. art. V, § 39 (requiring a supermajority of seventy-five percent for any budget that exceeds \$2.5 million in spending on items other than education, highways, confederate pensions, and state debt).

208. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 196, at 6.

209. *Id.* at 7.

210. *Id.*

211. *Id.*; see also N.C. CONST. art. III, § 5(3) (requiring the Governor to maintain a balanced budget during the fiscal year).

212. See *infra* notes 229–32 and accompanying text.

213. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 196, at 8 (noting that Kansas and Kentucky deposit money for state budget stabilization funds by appropriation).

214. See *id.*

215. *Id.* (noting that Colorado has an automatic mechanism).

216. COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 13.

217. *Id.* at 9.

218. N.C. CONST. art. II, § 22(1).

citizens go through life relying exclusively on savings,²¹⁹ so too can governments be expected to run into severe—though temporary—shortfalls caused either by recessions or unpredictable expenditures resulting from, for example, natural disasters.²²⁰ If states like North Carolina should no longer be held to such strict budgetary requirements,²²¹ there needs to be some workable policy solution that gives policymakers flexibility, while at the same time not giving the foxes the keys to the henhouse. Unrestricted, chronic borrowing remains as economically destructive as it was perceived to be in the eighteenth and early nineteenth centuries, when the American system of governance was being codified.²²² Even though the Model State Constitution does not restrict borrowing,²²³ such a permissive recommendation would run the risk of creating precisely the temptation against which the balanced budget provision was designed to protect.

Perhaps the single biggest contributor to this danger is the public choice problem that lawmakers who pledge the state's full faith and credit in return for long-term debt do not internalize the full cost of their actions. Most legislators are highly unlikely to be in the legislature by the time a twenty- or thirty-year bond fully matures.²²⁴ For that reason, they face a skewed incentive structure; as profit maximizers, they will face the temptation of creating a project in the present time or lowering taxes to the great applause of their constituents while writing off the cost to a later generation of

219. See F. H. Buckley, *The Debtor as Victim*, 87 CORNELL L. REV. 1078, 1081 (2002) (reviewing TERESA A. SULLIVAN ET AL., *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* (2000)).

220. See *supra* notes 157–62 and accompanying text.

221. Approximately half of the states require not just balanced budgets to be proposed but also to be either passed or implemented by the executive. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, *supra* note 196, at 6.

222. In general, early American politicians were highly skeptical of public debt and worried that it, in the words of President Jefferson, could constitute “the greatest of the dangers to be feared” in the American governmental experiment. *Id.* at 13. Even the statist Alexander Hamilton recommended that public debt be avoided so as to build the nation's credit. *Id.* President Jackson built a good portion of his presidency around abolishing the national debt and has the distinction of being the only president in the nation's history to have passed on a debt-free government to his successor. *Id.* at 13–14. For more on period views on public debt, see generally William Breit, *Starving the Leviathan: Balanced Budget Prescriptions before Keynes*, in FISCAL RESPONSIBILITY IN CONSTITUTIONAL DEMOCRACY (James M. Buchanan & Richard E. Wagner eds., 1978).

223. Article VII of the Model State Constitution does not contain a balanced budget provision. See MODEL STATE CONSTITUTION art. VII (Nat'l Mun. League 1968).

224. See generally Einer Elhauge, *Are Term Limits Undemocratic?*, 64 U. CHI. L. REV. 83, 146 (1997) (stating that the average tenure, even at the higher rates of incumbency in the period studied, was about twelve years for persons in the United States Congress).

taxpayers.²²⁵ Such may be the case for the current federal debt load, currently over \$4.5 trillion.²²⁶ It is hardly surprising that there are no constitutional limitations on the national Congress in maintaining fiscal responsibility.

B. Procedural Alternatives

Currently, state and federal governments in the United States restrict themselves to no debt without referendum or virtually unrestricted borrowing, or various procedural limitations on debt creation in the legislative process.²²⁷ Within that range, there are a number of mechanisms between utter fiscal freedom and the absolute prohibition on state debt without a referendum/special exception. One possibility is simply to make the balanced budget requirement statutory instead of constitutional. This approach, however, is probably neither realistic nor particularly desirable. At the practical level, the General Assembly might pass a statute that provided that, should a voter referendum on repealing the constitutional balanced budget requirement pass, a statutory mandate would become effective. Of course, such a deal with the voters would still amount to the legislature asking the citizenry to give it the keys to the henhouse just to keep it safe. While a legislature that later decided to void the statute would probably face the wrath of the voters, a shrewd legislature would be able to chip away at the law so as to render it ineffective while flying under their constituents' political radar.

More palatable would be constitutional amendments that limit the legislature in some appropriate manner. Requiring a supermajority—perhaps either three-fifths or two-thirds—of both houses of the General Assembly in order to create public debt without voter approval would be one such check, virtually requiring some form of bipartisan resolve in order to create debt. While this would give a unified legislature flexibility to deal with a budget crisis with whatever financial instrument it sees as appropriate, it does not fully deal with the public choice problem of lawmakers putting off payment until after they leave office.

225. See Brown, *supra* note 186, at 643–44.

226. Kaye, *supra* note 107, at 156–57. See generally Neal Devins, *Budget Reform and the Balance of Powers*, 31 WM. & MARY L. REV. 993, 993 (1990) (discussing budget deficit from the purview of fifteen years ago).

227. Cynthia Sneed, *An Examination of the Effects of Balanced Budget Laws on State Borrowing Costs*, 14 J. PUB. BUDGETING ACCT. & FIN. MGMT. 159, 162–64 (Winter 2002) (providing a “summary of the state balanced budget laws including where in the budgeting process the budget is required to be balanced”).

C. Substantive Alternatives

In addition to the above procedural devices, there are a number of financial tools designed to alleviate fiscal fluctuations under the constraint of heightened policy obligations.²²⁸ First, an increase in the size of the required contribution to the Savings Reserve Fund, or rainy day fund, would help to mandate greater fiscal austerity.²²⁹ Currently, the State must deposit twenty-five percent of the money collected in taxes but not allocated in a given fiscal year.²³⁰ By raising this requirement to, for example, fifty percent, the State would merely be requiring that more of the windfall from a stronger-than-expected economy would be reserved for future needs. This recommendation, adopted by the Governor's Commission to Modernize State Finances,²³¹ makes excellent sense, but it does not solve the problem of unforeseen fiscal shocks.²³²

Moreover, as the rainy day fund increases in size, this perverse incentive structure creates an incentive for lawmakers to fabricate or exaggerate crises in a given governmental program, crises that call for spending out of the rainy day fund. Given that lawmakers do not know when a recession will occur, they will, facing uncertainty, be even more inclined to spend the money in the current time period, given that the general expectation during economic booms is that they will continue for the foreseeable future. The perceived current need for a given program is simply more palpable than the unforeseen, speculative future recessionary need. Lastly, even if the legislature were to act in an unusually prudent manner and save for the future, the rainy day fund does involve tying up economic resources in the government's coffers.

Going the opposite direction and simply requiring spending cuts in down years would solve the problem, albeit in a rather harsh manner. While this Comment strongly contends that spending cuts which follow declines in tax receipts are bad policy in the modern governing environment, it must mention the alternative. Not only is it a major part of the current approach, but also it has intuitive appeal for a private citizen who would rather have guaranteed austerity in

228. See generally BUDGET PROCESSES IN THE STATES, *supra* note 196, at 59–66 (summarizing the contingency fund programs in all fifty states).

229. See COMM'N TO MODERNIZE STATE FINANCES, *supra* note 35, at 14 (recommending an increase in the mandatory contribution to the Savings Reserve Account).

230. *Id.* at 13.

231. *Id.* at 14.

232. See *supra* notes 150–63 and accompanying text.

the state budget than have to engage in the costs of overseeing the public sector's fiscal responsibility as a voter. This Comment, however, takes the position that the modern tax structure, policy priorities, the heightened need for public spending in recessionary periods, and recent judicial trends require greater flexibility in order to create the optimal state governing situation.

Mechanisms that best internalize the cost of debt are most preferable, because they would give legislators the incentive to design fiscal policy with fuller consideration of the true costs of deficit spending. They also lower the need for citizens to oversee whether their representatives are acting in a fiscally responsible manner. One plausible mechanism would preserve the balanced budget requirement but change it to a longer-term balance, in which only the four-year total need be debt-free. In effect, it preserves the existing mechanism but allows for more flexibility in the event of a short-term fiscal shock. The advantage of this mechanism is its intuitive appeal. In the practical setting of a voter referendum, amendment proponents can make the argument that the legislature could have planned better around the current fiscal pinch had it been able to deal with a four-year budgetary cycle instead of the current two-year cycle. Further, by aligning this period with the governor's four-year term, the voters can hold the executive clearly accountable for a four-year plan.

The downside of this proposition is that the uncertainty of forecasting into the future remains. While it would give lawmakers greater flexibility if a shortfall occurred early in the four-year cycle, it would hardly be different from the current system if the unanticipated shortfall occurred in the last year of the cycle. In that situation, as in the current one, solvency in that year would depend on ex ante saving for the uncertain future.

D. A Deal: Short Term Debt Creation Plus a Cap on Spending Increases

Perhaps the best instrument for the voters to give to the legislature and governor would be the power to create short-term debt without a referendum. By delegating the power to create fiscal instruments like a five-year bond, the problem of predicting future shortfalls is avoided, while the legislature still must pay the debt back soon enough that the legislators and/or political party that advocated for the bonds would remain closely connected to their maturation date. Even if individual legislators retire before the maturation date of the five-year bond, their political party would likely still remain accountable to the electorate for responsible decision-making.

Because bonds would be short-term, there would be significantly less opportunity to run up a lot of debt. Lastly, policymakers would have the benefit of planning for the future based on a clearer picture of the problem. Once the problem comes into focus, a more precise budget can be crafted using responsible borrowing while maintaining fiscal balance. The problem of having to go through the particularly cumbersome and uncertain referendum procedure would be unnecessary, except in the case where some over-arching problem required long-term debt.²³³ This solution, then, achieves the intuitively appealing result of broadening the fiscal period to a five-year period while allowing solutions to be crafted as problems arise. Because the period is so short, there is a strong disincentive to rack up enormous amounts of debt like the federal government has done while still giving the legislature the power to deal flexibly with problems as they manifest themselves.

Allowing for short-term debt instruments without a referendum gives the legislature an incentive to overspend, however, given that a legislature can continue to add to the debt load with ever-larger short-term debt creation. So, while short-term debt partially internalizes the political costs of borrowing, it does not do so completely. For that reason, a companion constitutional provision that restricts expenditures to a set percentage of the state's gross domestic product would give the voters the assurance that the underlying overall tax bill would not spiral out of control. Expenditure limitations are increasingly popular across the country.²³⁴ Tying increases in expenditures to the growth in personal income without a voter referendum can be a strong form of restraining the public sector²³⁵ and can offset the greater flexibility of added

233. As a testament to the difficulty of this procedure, it took a monumental, multi-million dollar lobbying effort to get the higher education bond referendum passed in North Carolina's 2002 general election. The bill to put the referendum on the ballot unanimously passed both houses of the General Assembly, and the fiscally conservative N.C. Citizens for Business and Industry led the publicity campaign for the referendum. See Jane Stancill, *\$3.1 Billion Plan for N.C. Colleges Heads to Voters*, NEWS & OBSERVER (Raleigh, N.C.), May 19, 2000, at B1. As further testament to the energetic support the referendum got from the state's leaders, news articles like this one virtually read like press releases from the pro-referendum lobby.

234. See Michael J. New, *Limiting Government Through Direct Democracy: The Case of State Tax and Expenditure Limitations*, POL'Y ANALYSIS No. 420, Dec. 13, 2001, at 4. See generally John Hood, John Locke Foundation, *Follow Easley's Lead: Spending Cap Should Be Tightened*, CONSTITUTIONAL SPOTLIGHT No. 228, Mar. 6, 2003, at 2 (providing a brief overview of the trend towards statutory and constitutional spending limitations), available at http://www.johnlocke.org/acrobat/spotlights/3_6_03_spending_cap.pdf.

235. But see Tobin, *supra* note 1, at 155 (contending that a serious drawback of adding constitutional limits on the budgetary process is increased judicial activism in budget

flexibility in financing that would come from the above debt proposal.

This two-tiered referendum operates essentially as a bargain that the legislature offers to the voters. In return for having greater flexibility to smooth out sources of revenue, it consents to being subjected to a strict cap on spending, which is, in the long run, simply the definition of the liabilities that the government creates and for which taxpayers are ultimately responsible. Both parties therefore get what they most desire. The taxpayers get more assurance of fiscal austerity than they currently have, and the General Assembly has more fiscal flexibility to manage the continuity of government services and to deal with short-term revenue shocks, a flexibility which, as argued in Part II, it sorely needs in the modern economic and policy environment.²³⁶ In the long run, politicians even benefit somewhat from a spending growth cap because it reduces the ability of the legislature during expansionary periods to spend as much as it receives in the increased revenues coming from corporate and personal income taxes, therefore creating expectations within and outside the government for continued services at that level. The fact that a legislature in the following economic recession cannot possibly maintain that level of services absent a tax increase unfairly penalizes the recession-era government in the political sphere while unfairly rewarding the boom-era government.

That is precisely, however, what happened in North Carolina and across the country in the 1990s expansion versus the early 2000s recession. The unrealistic expectation of never-ending high state revenues mushroomed government services during the 1990s²³⁷ and left the subsequent politicians with the problem of having to deal out the tough medicine when revenues collapsed and the fiscal crisis developed.²³⁸ It is no surprise that Governor Easley, the recession-era

matters). Professor Tobin's concern certainly has been borne out in *Guinn v. Legislature*, where the Nevada Supreme Court decided to suspend part of the constitution as a solution to a political budget impasse. See generally *Guinn v. Legislature*, 71 P.3d 1269 (Nev. 2003), *reh'g dismissed, clarified* 76 P.3d 22 (Nev. 2003) (declaring a constitutional provision requiring a two-thirds supermajority for revenue raising legislation void as inconsistent with the constitutional requirement to fund public education); *supra* notes 189–95 and accompanying text.

236. Part II, *infra*, develops a case for converging statutory, legal, and economic trends creating a systemic fiscal dilemma for state government. See also Fino, *supra* note 48, at 775 (describing the financial impracticalities of voter referenda that constrain state financial flexibility on the revenue side while calling for ongoing programs involving substantial spending).

237. See *supra* notes 18, 53–63 and accompanying text.

238. See *supra* notes 17–18, 150–52 and accompanying text.

governor, has proposed a spending cap,²³⁹ as his administration has had to bargain with the General Assembly to hammer out the unpopular cuts to programs that were so enthusiastically expanded in the previous eight years.²⁴⁰

Expenditure limits now exist in well over half the states, either in statutory or in constitutional form.²⁴¹ The evidence on their ability to restrain fiscal expansion is increasingly robust.²⁴² Innovation at the state level in expenditure limit mechanisms has been substantial. For example, Colorado has perhaps the most austere form of spending cap: its current form is a constitutional limit that bars increases in spending beyond the previous year's level plus the rate of inflation.²⁴³ Connecticut²⁴⁴ and Michigan,²⁴⁵ on the other hand, have spending restrictions tied to increases in personal income, such that the overall percentage of income that goes to the state government remains relatively constant absent voter approval. Regardless of which specific mechanism would be chosen, the deal would remain the

239. See Eric Dyer, *Easley Backs Spending Cap*, GREENSBORO NEWS & RECORD, Feb. 25, 2003, at B12; see generally CONN. CONFERENCE OF MUNICIPALITIES, CONNECTICUT'S SPENDING CAP: WHAT ARE THE FACTS? (Jan. 25, 2000) (noting that the Connecticut spending cap originated during a recessionary period in 1991 in response to the fiscal dilemmas of that budgetary period), <http://www.ccm-ct.org/news/2000/cap6.pdf> (on file with the North Carolina Law Review).

240. See *supra* notes 17–19 and accompanying text.

241. New, *supra* note 234, at 4; see, e.g., CONN. CONST. art. III, § 18. The amendment states, in relevant part:

The general assembly shall not authorize an increase in general budget expenditures for any fiscal year above the amount of general budget expenditures authorized for the previous fiscal year by a percentage which exceeds the greater of the percentage increase in personal income or the percentage increase in inflation, unless the governor declares an emergency or the existence of extraordinary circumstances and at least three-fifths of the members of each house of the general assembly vote to exceed such limit for the purposes of such emergency or extraordinary circumstances.

Id.

242. See New, *supra* note 234, at 5–6. But see James Bennett & Thomas DiLorenzo, *Off-Budget Activities of Local Governments: The Bane of the Tax Revolt*, 39 PUB. CHOICE 333–34 (1982) (noting that states can get around state-level spending limits by giving responsibilities to local governments). In North Carolina, that criticism would be less applicable, given that local governments are bound by the general prohibition on debt creation absent a referendum. N.C. CONST. art. V, § 4. In addition, municipalities can only impose taxes that the General Assembly authorizes. N.C. GEN. STAT. § 160A-206 (2001).

243. COLO. CONST. art. X, § 20 (“The Taxpayer’s Bill of Rights”); see also CAL. CONST. art. XIII B, § 1 (limiting increases in parts of the state budget to inflation plus population growth). Cf. New, *supra* note 234, at 4 (noting that this limitation does not pertain to total expenditures).

244. CONN. CONST. art. III, § 18.

245. MICH. CONST. art. IX, § 26.

same: the voters give the legislature flexibility in return for spending restrictions. Such a bargain would provide an incentive for the legislature to put the referendum on the ballot, as well as for the voters to ratify the amendments. The end result would be fiscal austerity combined with the financial maturity that would give the State a much stronger position in advocating for greater responsibility over public policy matters at the federal level. With greater accountability to the citizens with respect to spending, as well as greatly expanded flexibility to provide continuous services across revenue fluctuations, this approach would combine the best of both worlds and answer perhaps one of the greater objections to federalism—the question of whether the states are better equipped to deal with policy problems than the federal government.²⁴⁶ This recurring theme affects all areas of law in questions of federal-state relations—congressional legislation,²⁴⁷ federal administrative decisions,²⁴⁸ and constitutional trends.²⁴⁹

CONCLUSION

North Carolina is but one of forty-eight states that are projected to face fiscal shortfalls for 2003–04.²⁵⁰ While aid from the federal government to help stem the problem would be a convenient fix,²⁵¹ the large budget deficit at the federal level, along with impending tax

246. See, e.g., William W. Buzbee, *Brownfields, Environmental Federalism, and Institutional Determinism*, 21 WM. & MARY ENVTL. L. & POL'Y REV. 1, 3 (1997) (contending that the federal government has generally outpaced the states in expertise regarding environmental policy); Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PA. L. REV. 2341, 2375 n.123 (1996) (arguing that the federal government has a strong argument for control over environmental policy because of its greater expertise that states have trouble duplicating); Joel H. Swift, *Fiscal Federalism: Who Controls the States' Purse Strings?*, 63 TEMP. L. REV. 251, 254 (1990) (“[I]ndependent state initiation of spending programs, such as unemployment compensation insurance and income assistance to dependent families, has furthered the states’ function as ‘laboratories for experimentation’ within our federal system.”). For a discussion of judicial enforcement of constitutionally based federalism principles as a policy matter, see *United States v. Lopez*, 514 U.S. 549, 583 (1995); Ann Althouse, *Inside the Federalism Cases: Concern About the Federal Courts*, 574 ANNALS 132, 137 (2001); *supra* notes 90–97, 106–10, 130–40 and accompanying text.

247. See *supra* notes 68–98 and accompanying text.

248. See *supra* notes 99–105 and accompanying text.

249. See *supra* notes 134–43 and accompanying text.

250. Kane, *supra* note 43; see also IRIS J. LAV & NICHOLAS JOHNSON, STATE BUDGET DEFICITS FOR FISCAL YEAR 2004 ARE HUGE AND GROWING 1–2 (Center on Budget and Policy Priorities 2003) (projecting continued fiscal trouble across the country in fiscal year 2004), available at <http://www.cbpp.org/12-23-02sfp.pdf>.

251. See generally LAV, *supra* note 2 (arguing that federal aid is the best way to alleviate the ongoing state fiscal crises).

cuts and a Republican-controlled Congress and White House,²⁵² makes a federal bail-out unlikely. North Carolina has used many of its short-term fixes and still faces a projected deficit.²⁵³ Having already identified many budget cuts that are less painful and used up its reserve of one-time fixes,²⁵⁴ 2003–04 promises to be another budget full of particularly difficult decisions. Without the benefit of flexible financing, it is hard to believe that short-term fixes with long-term greater costs, scrapped valuable investments, and neglected new responsibilities will not be prominent features of the budget. Like many states across the nation, many disparate trends have converged to create what is not merely a temporary fiscal crisis, but may well turn into a more fundamental crisis in confidence in state government's power to deal with modern policy problems. If states are to advocate for more state and local control of policy issues and for flexibility to innovate in the area of government services, they will continue to undercut their own arguments by the crippling nature of their financial capabilities. Gone are the days when state and local governments financed their pursuits with the stable property tax and policy objectives were limited in an agrarian society. North Carolina, the case in point for this Comment, commands a budget of \$14 billion, a budget larger than that of Pakistan, the Philippines, or even Kuwait.²⁵⁵ Current political as well as federal judicial trends promote the importance of governmental action at the state level. A compelling case exists that the state constitution has not kept up with the times and that North Carolina has an opportunity to take a leadership position and strike an important new path towards modernization of state government in the American system. As John J. Parker, former Chief Judge of the Fourth Circuit Court of Appeals stated regarding the role of the state constitution:

The purpose of a state constitution is two-fold: (1) to protect the rights of the individual from encroachment by the state; and (2) to provide a framework of government for the state and its subdivisions. It is not the function of a constitution to deal with temporary conditions, but to lay down general principles of government which must be observed amid changing conditions. It follows, then, that a constitution should not contain elaborate

252. See Lawrence M. O'Rourke, *Bush's Economic Advisors Quit*, NEWS & OBSERVER (Raleigh, N.C.), Dec. 7, 2002, at A1.

253. Kane, *supra* note 43.

254. *Id.*

255. Rob Christensen, *The Legislature*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 26, 2003, at 1AA.

legislative provisions, but should lay down briefly and clearly fundamental principles upon which government shall proceed, leaving it to the people's representatives to apply these principles through legislation to conditions as they arise.²⁵⁶

The current North Carolina constitution, like that of many state constitutions, erects an inflexible legislative provision about how to finance and cope with trends in law, policy, and the economy. A public reassessment of long-standing restrictions on state debt would contribute greatly to the effectiveness of the modern state and its fundamental place in the American system of federalism.

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256. Sanders, *supra* note 14, at 50.